1975

Audits of savings and loan associations (1975); Industry audit guide; Audit and accounting guide

American Institute of Certified Public Accountants. Committee on Savings and Loan Accounting and Auditing

AICPA

American Institute of Certified Public Accountants

INDUSTRY AUDIT GUIDE

AUDITS OF SAVINGS AND LOAN ASSOCIATIONS

PREPARED BY THE COMMITTEE ON SAVINGS AND LOAN ACCOUNTING AND AUDITING

Including

STATEMENT OF POSITION

Note: This volume includes both the industry audit guide, *Audits of Savings and Loan Associations,* as it was originally published in 1973 and Statement of Position on Savings and Loan Subordinated Debt, issued by the Accounting Standards Division in 1974. In using the guide, readers should refer to the additional material in the Statement of Position (see pages 107-109), which was not available when the guide was issued, with respect to the classification of subordinated debt securities.

D. R. Carmichael, *Director*
Auditing Standards

AUDITS OF SAVINGS AND LOAN ASSOCIATIONS

Including

STATEMENT OF POSITION

American Institute of Certified Public Accountants
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NOTICE TO READERS

This audit guide is published for the guidance of members of the Institute in examining and reporting on financial statements of savings and loan associations. It represents the considered opinion of the Committee on Savings and Loan Accounting and Auditing and as such contains the best thought of the profession as to the best practices in this area of financial reporting. Members should be aware that they may be called upon to justify departures from the Committee's recommendations.

Committee on Savings and Loan Accounting and Auditing
(1971-72)

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AUDITS OF SAVINGS AND LOAN ASSOCIATIONS

PREPARED BY THE COMMITTEE ON
SAVINGS AND LOAN
ACCOUNTING AND AUDITING

American Institute of Certified Public Accountants

Table of Contents

Preface

This is the fourth edition of *Audits of Savings and Loan Associations*. Earlier editions were issued in July 1940, March 1951, and September 1962. Like prior ones, this edition has been prepared to assist the independent auditor in examining the financial statements of a savings and loan association.

The Committee believes that generally accepted accounting principles and auditing standards, as they pertain to business transactions in general, are applicable to financial statements prepared for savings and loan associations. In this context, this edition has been updated to give effect to accounting and auditing developments peculiar to the industry that have occurred since 1962, so that the independent auditor may more effectively serve his clients. In addition to general information regarding the savings and loan association industry, the guide includes the character and extent of regulations and their general effect upon the policies and practices of associations; proper methods of accounting to be followed for recording major transactions; basic forms of financial statements; and the independent auditor's report. Suggested auditing procedures with respect to major accounts are also presented. The extent to which these auditing procedures may apply to any particular examination will vary depending upon the size, type of organization and the existing system of internal control. Therefore, programs for each audit should be designed to meet the requirements of a particular engagement.

The accounting practices recommended in the guide differ, in some instances, from those presently followed by the industry. In this connection, it is the considered opinion of the Committee that the financial statements of all associations, for fiscal periods beginning after December 31, 1972, should conform to the recommended accounting practices as set forth herein. Earlier compliance is encouraged.

Committee on Savings and
Loan Accounting and Auditing

August 1972

Organization and Regulation

General Information

There are in the United States approximately 6,000 savings and loan associations, which are corporations chartered either by the state in which they operate or the Federal Home Loan Bank Board (FHLBB). All associations chartered by the Federal Home Loan Bank Board are known as "federal" associations and have the word "federal" in their corporate names. The majority of the savings and loan associations, including all federal associations, are mutual institutions; they are owned by the savers who, together with the borrowers, are members entitled to vote at the annual meeting.

Most states provide for the organization of mutual associations. In addition, several states provide for capital stock associations—associations which are authorized by state charter to issue and sell capital stock (sometimes called permanent reserve shares, guaranty stock or guarantee stock) to investors. This capital stock represents equity capital which is nonwithdrawable, and it is not insured by the Federal Savings and Loan Insurance Corporation (FSLIC).

The applicable laws and regulations of the states vary but usually include requirements or restrictions concerning issuance of capital stock, such as a minimum amount of initial consideration, the rights of stockholders or the payment of dividends. These requirements may be considerably more restrictive than those generally applicable to other corporations. In the event that the meaning and applicability of the regulatory rules and regulations are not clear and interpretation is necessary, the auditor should request the association to obtain an opinion from an attorney or from the regulatory authority.

Associations have various classes of savings accounts as authorized by supervisory authorities. These accounts may include passbook savings accounts, savings certificates, investment certificates, withdrawable or repurchasable shares and others. Savers in a mutual association, as the members of the association, under federal regulations have one vote for each $100.00 of savings or fraction thereof, up to a maximum of 50 votes. In some states the savers in capital stock associations are also members with similar voting rights; in others, the savers have a creditor relationship.

All federal associations are subject to the rules and regulations of the FSLIC (Rules and Regulations for Insurance of Accounts) and the FHLBB (Rules and Regulations for the Federal Savings and Loan System). State-chartered associations are subject to the laws and regulations of the state under whose charter they operate and if insured are also subject to the rules and regulations of the Federal Home Loan Bank System and the FSLIC.

Some of the rules and regulations governing both federal and state-chartered associations pertain to accounting, although the majority of regulations pertain to investments, savings accounts and operations. The independent auditor should familiarize himself with the rules and regulations of the applicable supervisory authorities and be informed of current revisions.

The accrual basis of accounting is the only acceptable basis of accounting under generally accepted accounting principles for business enterprises. Effective for years after 1969, regulations of the FHLBB require that insured institutions, with certain exceptions, prepare their financial statements on the accrual basis of accounting. All other associations are urged to use the accrual basis of accounting.

The auditor may, however, encounter other bases of accounting, such as cash and the modified accrual basis. Under the latter method, an association may record certain items such as interest income from investments and interest expense on borrowed money on the accrual method, whereas other items of income and expense may be recorded on the cash basis. When there are variations from generally accepted accounting principles, the independent auditor must exercise his judgment in determining whether or not a qualified opinion or an adverse opinion is required. However, the auditor should be aware that the FHLBB will reject an audit report which contains a qualified opinion in cases where it has been determined that extended auditing procedures or appropriate adjustments would enable the issuance of an unqualified opinion.

Insurance of Accounts

The savings accounts of all federal savings and loan associations are required to be insured by the FSLIC under Title IV of the National Housing Act, as amended. Other eligible savings and loan, building and loan, homestead associations or cooperative banks may also obtain such insurance from the FSLIC.

Rules and Regulations for Insurance of Accounts (Chapter V(d), Title 12, of the Code of Federal Regulations) has been issued by the FSLIC. The independent auditor should be familiar with the current provisions of these rules and regulations and should make such tests as may be necessary in the circumstances to satisfy himself that the insured association is complying with applicable regulations that might materially affect an association's financial position or results of operations.

Independent Audits and Supervisory Examinations

Under *Rules and Regulations for Insurance of Accounts,* all federal associations and state-chartered associations whose accounts are insured by the FSLIC are subject to examination by the Office of Examinations and Supervision of the FHLBB. Frequently, joint examinations of state-chartered associations are made by the Office of Examinations and Supervision of the FHLBB and by the state regulatory authority which examines and supervises such associations. The independent auditor should review and become familiar with examination reports prepared by the regulatory authorities.

Regulations of the FHLBB require that each insured institution be audited at least once in each calendar year by auditors and in a manner satisfactory to the FSLIC. (In a few prescribed circumstances, this requirement may be waived.) The audit requirement must be satisfied by an audit by independent public accountants or, if specified conditions are met, by internal auditors. The independent auditor must be thoroughly familiar with the rules and regulations of the FHLBB regarding audits of insured institutions. Present regulations deal with such matters as requirements for audits, qualifications of public accountants, independence of public accountants, and reports of audits.

In addition, the Office of Examinations and Supervision of the FHLBB has published supplemental rules setting forth certain requirements regarding audits of insured institutions. The Office of Examinations and Supervision will make a supervisory examination (as distinguished from an audit) principally to ascertain whether the association is being operated soundly and in accordance with the applicable laws and regulations. To accomplish the objective of the supervisory examination, usually the examiners do not perform the audit procedures that are required to express an opinion on financial statements.

The scope of state supervisory examinations of state-chartered associations that have independent audits varies from one state to another. It is not practical to cover the policy of each state in this publication; however, in some states the policy is quite similar to that of federal authorities.

* * *

Copies of the current FHLBB Statements on Accounting and Auditing Policies and PA Bulletins can be obtained from the Chief Examiner in each FHLB District or the FHLBB in Washington, D.C.

Auditing – General

Planning the Audit

Thorough planning is important to the successful examination of the financial statements of a savings and loan association. The general information needed for this purpose is usually developed by a preliminary investigation made prior to beginning the actual audit. This preliminary investigation should include a review of reports received by an association resulting from supervisory examinations by federal or state examiners since the date of the preceding audit.

Examples of the information to be assembled and the arrangements to be considered when planning the audit are as follows:

1. *General*
   - Location of offices
   - Office hours of employees
   - Hours opened to the public for business
   - Personnel requirements–interim and year-end
   - Letters of accreditation for audit personnel
   - Type of window machines and other bookkeeping or data processing equipment
   - Daily close-out procedures
   - Confirmation supplies required
2. *Internal control*
   - Preliminary evaluation–main office and branches

3. *Cash*
   Number of tellers
   Number of bank accounts
   Approximate volume of receipts and disbursements (number of transactions), etc.
   Number and location of cash funds (other than teller funds)
4. *Control of cash equivalent items*
   Location of securities
   Location of consigned items, such as savings bonds, travelers checks, etc.
5. *Loans*
   Number of accounts by major classes of loans
   Participations purchased or sold
   Location of detail and control accounts
6. *Savings accounts*
   Number of accounts
   Location of detail and control accounts
   Interest payment dates

Timing of the Audit. Federal associations are required to use a fiscal year ending December 31 and to submit periodic reports to the FHLBB. The fiscal year of most state-chartered associations also is a calendar year. Usually state-chartered associations are required to submit, at least annually, a report to state authorities.

The FHLBB requires that the audit cover four calendar quarters and recommends that the financial statements contained in the audit report cover a period ending at the close of a fiscal quarter. While an independent auditor's opinion is not required on financial statements contained in supervisory reports submitted to the FHLBB, the audited financial statements or footnotes thereto must contain a reconciliation of any differences in the net income and net worth contained in the applicable FHLBB report.

The rules and regulations of various state supervisory authorities should be reviewed to determine whether an independent auditor's opinion on financial statements is required in annual reports filed by a state association with state supervisory authorities. Some capital stock associations or their holding companies will be subject to the reporting requirements of the Securities and Exchange Commission and therefore will require audited financial statements for their fiscal year.

Except as noted in the preceding paragraph, there generally is no need for the date of the independent audit to coincide with the fiscal year end of the association. The audit date may be agreed upon with the association. In many cases, the independent auditor can time his audit date to avoid conflict with the federal and state examinations. The independent auditor should notify the appropriate supervisory authorities well in advance of the proposed commencement date of the independent examination. Timing of the audit also may be affected by an association's plans for changes in personnel, office space, accounting systems or equipment.

The independent auditor should ascertain the requirements of federal and state supervisory authorities regarding the time for submitting reports. Ordinarily the independent auditors' reports should be rendered to the association and the association should submit the required copies to the appropriate supervisory authorities.

Initial Audit Procedures. Audit procedures should be executed with a minimum of disruptions to an association's regular routine. Therefore, prior to the beginning of the audit, the staff assigned to the engagement should be assembled and thoroughly briefed as to the audit requirements. Specific assignments should be made.

Letters of accreditation should be obtained from the association to assure that the auditor's personnel gain access to each association office when the work is begun. Upon entering the association, the letters should be presented. If a surprise examination of selected key areas is deemed necessary, control over these areas should be established immediately. The extent of this control should be determined prior to the start of the field work, based on the auditor's understanding of the internal controls inherent in the system, and materiality of items involved. The following is a listing of several areas where immediate control should be considered: cash on hand, investment securities and consigned paper on hand, and subsidiary ledgers of loan and savings accounts. If necessary, securities and reserve or vault cash may be sealed to be counted later. Audit personnel should determine that the totals of loan and savings subsidiary ledgers are in agreement with the general ledger control accounts. As soon as the subsidiary ledger work is completed, confirmation requests may be prepared. Early in the audit, personnel in charge of the various segments of the audit work should begin an evaluation of the internal control and note any significant weaknesses which would serve as a basis for modification or extension of auditing procedures that are appropriate in the circumstances.

Internal Control

The selection of auditing procedures, their timing and the scope of the work performed will depend to a considerable extent upon the independent auditor's evaluation of the system of internal control. His review of the system of internal control as a basis for determining the scope of his work involves both the initial inquiry necessary to ascertain the association's procedures and such further investigations, tests, and inquiries during the audit as may be necessary to evaluate compliance with established accounting procedures, i.e., whether in fact the controls are functioning as represented.

Internal control over cash, loans receivable, securities owned, savings accounts, and the handling of transactions related to these items is of particular importance in savings and loan associations. For example, cash-handling functions should be segregated to the extent practicable from related record-keeping responsibilities; adequate controls should be established over savings accounts, including inactive accounts, and adequate controls should be established over lending procedures, including loan approvals, appraisal reports, document control, and the disbursement of loan proceeds.

The foregoing are among the major areas of internal control warranting special attention in the audit of a savings and loan association and are not intended to constitute an exhaustive discussion of internal control.

Many associations utilize some form of electronic data processing system. These systems may be (1) operated solely by an association, (2) shared on a cooperative basis with others, or (3) provided by an independent organization supplying specific data processing services for a fee. The auditor should review and evaluate the internal control features of an EDP system as he does other features of internal control over the association's operations. The effect of EDP systems on auditing procedures is discussed on page 11.

The independent auditor should make direct inquiries of, and obtain written representations from association officials as to any interests they may have in businesses with which the association deals. Consideration should be given to the nature of transactions with any businesses in which association officials have an interest, to the controls over these transactions and to disclosures, if any, which the auditor may deem appropriate.

Adequate fidelity bond coverage, an adequate accounting system with appropriate internal control, internal auditing and independent audits are essential elements in minimizing losses and discouraging irregularities. As mentioned in Chapter 1 of Statement on Auditing Procedure No. 33, audits of financial statements cannot be expected to detect fraud although such discovery may incidentally result. If, during the course of an examination, the independent auditor discovers any defalcation or violation of criminal laws, he should request the client to notify the proper federal and state authorities.

If the independent auditor's evaluation of internal control, made for the purposes of determining the extent of audit tests, reveals weaknesses in the system, the FHLBB requires that such weaknesses be reported to the association with recommendations for changes in procedures which will strengthen the existing internal control. Any letter or report to the association concerning such recommendations is required to be filed by the association with the FHLBB District Chief Examiner. Some states have similar requirements.

Confirmation

Confirmation requests will be used as part of the auditing procedures applied to many of the association's significant accounts, which may include:

1. Cash in banks.
2. Investments and securities held in safekeeping by others.
3. Loan accounts, including accounts previously written off.
4. Loans serviced by and for others.

5. Real estate sold on contract.
6. Savings accounts.
7. Advances from the FHLB and other borrowed money.
8. Consigned items such as savings bonds, travelers checks, and so forth.

The techniques followed in carrying out confirmation procedures for a savings and loan association should not differ from those employed in any other audit engagement and should include:

1. Determining that the total of the listings of accounts from which the confirmation selection is made is in agreement with control accounts.
2. Comparing data on the confirmation request with the association's records.
3. Maintaining control of the requests until mailed in an envelope with the auditor's return address. The mailing may include a return envelope addressed to the auditor.
4. Mailing second (and in some cases, third) requests for positive confirmations on accounts for which replies have not been received and performing alternative procedures when no reply is received.
5. Reconciling differences and clearing exceptions reported on replies.
6. Reviewing the results of confirmation requests to determine if any significant weaknesses in internal control have been disclosed and whether additional audit procedures should be applied.

Applications of Statistical Sampling

In 1962, the Committee on Statistical Sampling of the American Institute of Certified Public Accountants issued a report containing its opinion that the use of statistical sampling is permitted under generally accepted auditing standards. In 1963, the Committee on Auditing Procedure issued Statement on Auditing Procedure No. 33, "Auditing Standards and Procedures," which further sanctioned the use of statistical sampling techniques in determining the extent of audit tests and the methods for selecting items to be examined.

In audits of savings and loan associations, a number of auditing procedures lend themselves to statistical sampling. These would include examination of transactions for compliance with internal control procedures, confirmation, and other tests of savings and loan accounts. The auditor might consider using statistical sampling in these and other areas.

Auditing and EDP Systems

The use of electronic data processing equipment in businesses is extensive and is expected to increase rapidly in the future. The presence of a computer does not in any way affect the objective of the audit, i.e., the performance of the audit in accordance with generally accepted auditing standards for the purpose of expressing an opinion on financial statements. Nevertheless, the application of auditing procedures is significantly affected when accounts are maintained or controlled through a computer.

Audit procedures applied to accounting records maintained on EDP equipment may vary from those applied to records maintained manually or on mechanical equipment. Performing an audit of an automated system ordinarily should begin with an analysis of the entire system. It is not the purpose of this guide to discuss in detail audit techniques for use in connection with EDP-maintained records. Accordingly, special attention is called to the AICPA publication, *Auditing and EDP*, which provides information to assist an independent auditor in evaluating the system of internal control as a basis for determining the application of auditing procedures to accounting records maintained as a part of EDP systems.

Branches

Federal regulations provide that a branch office must be operated and directed from its home office and that the home office shall maintain control records of all business transacted at each branch. However, detailed records of all of its transactions may be kept at each branch.

The audit program may be the same for a branch as for the main office of the association and, in many instances, the examination of branches will be undertaken simultaneously. Associations with branches use one of three general systems of accounting, which are described on the following page.

1. A centralized system in which the home office maintains all primary and subsidiary ledgers, including individual savings and loan ledgers for the branch accounts.
2. A decentralized system in which the branch maintains its own general and individual account ledgers in the same manner as if it were a separate association.
3. A system which is partially centralized and partially decentralized.

The extent of the independent auditor's examination of branch accounts and supporting detail will depend upon the accounting system used and the effectiveness of the system of internal control. Cash and securities counts, confirmation programs and balancing of various subsidiary ledgers usually are conducted simultaneously at all locations when there are only a few branches or when internal control is not adequate. However, when in the judgment of the auditor the internal control over branches is satisfactory, audit procedures may be applied to selected branches at various times prior to completing the examination.

Charter, Bylaws and Minutes

Charters for federal savings and loan associations are issued by the FHLBB. The form of bylaws of such associations is also prescribed by the FHLBB. For state associations, the form of charter and bylaws is established by the state regulatory authority.

The requirements of the charter and bylaws should be reviewed at the start of the audit. The audit program should include such procedures as may be necessary to determine compliance with any charter and bylaw requirements which may have a material effect upon the financial statements.

Properly signed minutes of the meetings of the directors, committees of directors, operating committees, and of members or stockholders should be read, and any items therein which may have a significant effect on the financial transactions of the association should be noted. The independent auditor should then determine that material transactions affected have been executed and recorded in accordance with the minutes.

In addition to items usually included in corporate minutes, the minutes of an association will in most cases include approval of loans, transactions in real estate acquired by foreclosure or for investment, transfers to and from general reserves and income tax reserve accounts, purchases and sales of securities, the borrowing of funds from the FHLB or other sources, authorization and designation of terms of certain types of savings accounts, and interest rates on savings accounts.

Important transactions or matters which require action by the directors, the members or the stockholders (under the charter, the bylaws or established practice), but which are not covered in the minutes, should be called to the attention of the proper officials for appropriate action. If the matters involved have a material bearing on the financial statements, the independent auditor should satisfy himself that appropriate action is taken before releasing his report.

Compliance With Supervisory Regulations

The independent auditor should test compliance with supervisory rules and regulations that might materially affect the association's financial position or its results of operations. He should report to management any noncompliance with rules and regulations which come to his attention during the conduct of his examination.

Accounting Principles and Auditing Procedures

Cash on Hand and in Banks

The procedures used to audit cash transactions and balances in savings and loan associations are essentially the same as those used in any other business entity.

The independent auditor should establish, through prior investigation and current inquiry and observations, the other items to be controlled while the cash count is under way. He should guard against concealment of a material cash shortage by conversion of securities or other assets. The independent auditor may find unrecorded receipts, escrow funds, unissued government bonds, money orders, travelers checks or other items which he should control. Confirmation of the inventory of bonds, money orders, travelers checks and similar items usually should be obtained. It may be advisable for the independent auditor to obtain permission to make surprise cash counts during the year because at the date of the audit it may be difficult to accomplish a surprise visit.

To make a surprise count of cash, the independent auditor must assign sufficient staff to control the cash funds, which should be counted and reconciled with the control accounts. Simultaneous control should be maintained over negotiable securities until both cash and securities are satisfactorily accounted for. Consideration should be given to reconciling or examining the reconcilements of bank accounts in connection with the cash counts in addition to the examination of reconcilements made during the audit. Undeposited receipts on hand at the time of the cash count should be controlled until deposited and any items included in the deposit which are subsequently returned "unpaid" should be investigated.

It is the practice in some associations to delegate the disbursement of mortgage loan settlement funds to agents or trustees. The independent auditor should, in these instances, satisfy himself that the procedures used by the agents or trustees provide that funds advanced by the association will be recorded, deposited, and disbursed as intended. He should also establish by confirmation or by count the amount of cash funds held by a trustee or an agent for the account of the association at the audit date.

Investments in Securities

Federal and state regulations restrict the types of investment securities which may be purchased by savings and loan associations. The independent auditor should be familiar with such regulations.

Securities on hand should be counted or placed under control at the time of the cash count. Securities in safekeeping should be confirmed with the custodian. When securities are in an independent safe deposit box, the count can be made within a reasonable period before or after the cash count date, provided arrangements have been made in advance with the safe deposit company to furnish the independent auditor with a letter stating that there was no access to the box in the intervening period.

All stock certificates and registered bonds should be in the name of the association or, if in the names of others, they should be properly endorsed or accompanied by a power of attorney. When counting coupon bonds, it should be determined that unmatured coupons are intact.

Transactions during the period should be test checked against broker or dealer invoices, advices or other supporting data and appropriate minutes for approval. When the internal control over securities does not appear adequate, it may be advisable to compare the certificate numbers of the securities owned with the record of security purchases and sales.

Savings and loan associations which are members of the FHLB system are required to maintain a specified investment in shares of FHLB stock. The independent auditor should obtain confirmation from the regional FHLB of the stock owned in compliance with this requirement. The dollar amount of these shares should be compared with the association's general ledger.

Securities should be recorded at cost, including expenses incident to acquisition. Premiums and discounts should be amortized against investment income to achieve fair presentation of investment income and to comply with generally accepted accounting principles. The period for amortization of premiums and discounts usually should extend to the maturity date of the security. If the obligation has been issued with a call date falling prior to maturity, premiums should be amortized to the earlier call date, while discounts should be amortized to maturity.

If an association has not consistently amortized premiums or discounts in past periods, an adjustment may be required to correct the carrying value at the beginning of the period (to that which would have existed if generally accepted accounting principles had been followed from inception). The accounting presentation of the adjustment should be in conformity with applicable provisions of Accounting Principles Board Opinions relating to such changes.

Market values of individual securities should be obtained from published quotations or other independent sources and compared with carrying value. A parenthetical disclosure of market values should be made in the appropriate caption in the financial statements. In addition, securities that are pledged for bank borrowings or other purposes should be disclosed. When the comparison discloses a decline in the value of a security which is not due to temporary conditions, the decline should be recognized in the accounts by establishing an allowance for it with the resulting loss being recognized in the statement of income.

Since government obligations generally do not decline in value, except as a function of the fluctuation in interest rate, no allowance for a decline ordinarily is necessary if management intends to hold the securities to maturity. However, if at the time financial statements are prepared it is reasonable to expect the securities will be disposed of at a loss, the estimated loss should be recognized by charging current operations and creating an allowance for loss. The expectation of loss from disposal could result from various factors, including management decision, supervisory directives, regulatory requirements, or other circumstances. The allowance so created would be deducted from the asset account in arriving at the amount shown in the statement of financial condition. If an allowance for a material loss is not made in such circumstances, it may be necessary for the independent auditor to qualify his opinion, or give an adverse opinion, depending on the circumstances.

In addition, unless the independent auditor is able to satisfy himself that a sale of securities at a loss is not reasonably expected in the near future based upon existing conditions, it may be necessary for him to qualify his opinion or disclaim an opinion unless an adequate valuation allowance is established.

The Committee has concluded that gains and losses arising from security transactions should be recognized in the statement of income for the period in which the security is sold or otherwise disposed of by an association. Also, under the present FHLBB regulations, such gains and losses must be recognized at the time of sale.

The Committee has considered as an alternative the deferral and amortization method of accounting for such gains and losses. However, until application of this method is further clarified and until it receives wider acceptance within the profession and by regulatory agencies, the use of this method is considered to be inappropriate within the savings and loan industry.

Where an association has adopted a method other than recognition of gains and losses from security transactions in the period of sale or other disposition and where its effect on financial statements is material, the independent auditor should appropriately qualify his opinion or give an adverse opinion.

Loans

The various types of loans made by associations are discussed in the following paragraphs. The auditing procedures applicable to loans in general are discussed under "Auditing Loan Accounts," page 24.

Mortgage Loans. The principal business activity of savings and loan associations is supplying money for mortgage loans on real estate. The various supervisory authorities place many restrictions on such loans. These restrictions include, but are not limited to, such matters as authorized lending areas; loans to one borrower; loans to officers, directors or employees of associations;

and the aggregate amount of loans on certain types of property. In addition, associations must follow certain rules of investment in mortgage loans to qualify for the federal income tax benefits afforded savings and loan associations. Furthermore, an association's board of directors often adopts further limitations. The independent auditor should be generally familiar with lending rules, regulations and policies and should bring to the attention of management any apparent noncompliance.

Construction Loans. There are two principal types of construction loans, although variations may be encountered. One type is a loan to the owner of the property during the construction period only, with long-term financing arranged with someone other than the association. The second type is a loan granted to finance the owner-builder during the development of one or more real estate parcels and upon sale of the real estate the loan is converted to a long-term mortgage loan either through an assumption agreement with the purchaser or through a new loan. In the case of an assumption, the owner-builder who was the original obligor usually is released from secondary liability.

As construction progresses, requests are made by the builder for disbursement of a portion of the loan proceeds. The project should be inspected by the association to determine that construction has progressed to the point permitting the disbursements requested. Before disbursements are made, waivers of lien should be obtained from subcontractors (these generally are obtained by the builder).

Auditing procedures should be adapted to the variety of construction lending practices. The independent auditor should make a thorough examination of the association's policies and procedures regarding construction loans and make test checks of origination, approval, inspection, and disbursement procedures. It is recommended that associations prepare operations manuals setting forth policies and procedures. Such manuals would be beneficial in the administration of loan operations and would assist the independent auditor in carrying out his examination of lending procedures.

The independent auditor must satisfy himself that no material losses exist or are reasonably foreseeable. Construction loans frequently involve high risks and should be reviewed carefully in relation to an association's loan loss allowance. Many builders operate with minimum permanent capital and some keep poor records. Given this combination of factors and others, some builders overextend their lines of credit. A builder may incur losses in a project before he is even aware of the losses, or he may have difficulty selling homes and thereby fail to generate funds which are needed to complete other homes already under construction. The auditor must be alert to overconcentration of loans on large real estate developments when homes are not being currently sold. When there are losses or delinquencies on loans secured by real estate developed by one builder, the auditor should investigate other construction loans granted to the same builder. Similarly, when there are losses or delinquencies on loans secured by real estate which is concentrated in one location, the auditor should investigate loans on other properties in the location.

The independent auditor should consider visiting selected sites to confirm the existence of the buildings under construction and to observe the degree of their completion. The independent auditor should then compare his own observations with the association's inspection reports and builder's completion reports. In some circumstances the independent auditor should consider obtaining an independent evaluation of the status of construction. Any apparent variances should be examined further and discussed with the appropriate officials of the association; provisions should be made for possible losses.

Land Development Loans. Development refers to the installation of improvements to unimproved land which are necessary to produce building sites ready for construction. Land development loans include (1) loans on developed building lots, (2) loans to finance the acquisition and the development of unimproved land, and (3) loans on unimproved land. When an association is permitted by regulation to make loans on unimproved land, land held by the association for development may be sold to builders with a view towards generating a demand for construction loans, and long-term mortgage loans.

Property Improvement Loans. Associations may make the following types of property improvement loans: FHA-insured loans, VA-guaranteed loans, and uninsured loans. These loans are for the purpose of financing alterations, repairs and improvements to real property and are made on a monthly amortization basis. They are generally unsecured; however, associations occasionally require collateral and frequently a lien will be recorded in the public records. VA-guaranteed improvement loans are rarely encountered. Loans made during the period under examination should be tested for compliance with established policies of the association.

Associations holding a substantial number of property improvement loans may have acquired them through building material and supply companies or other parties. The seller's reputation and his performance on similar work in the past, as well as his present financial condition, are important factors to be considered.

Dealer originated loans usually are purchased without recourse. However, if the loan is not insured, the association may require a dealer reserve and, in addition, may hold back a portion of the proceeds until the loan is paid down to a certain amount. Losses sustained by the association on these loans are generally charged against the dealer's reserve and holdback accounts. Confirmation of reserves and holdbacks should be considered and charges to such accounts should be reviewed to determine whether they are in accordance with the terms of agreements with dealers. Loans paid off prior to maturity should be tested to determine whether the rebates allowed conform to the association's policies and FHA regulations, if applicable.

The required documentation for property improvement loans generally is as follows: (1) a note, endorsed when appropriate, (2) a completed loan application executed by the borrower, (3) a contractor's completion report executed by the contractor and/or the borrower, (4) an FHA insurance report, if applicable, and (5) evidence of additional collateral, if any. Other than the insurance report, the documents for uninsured loans are similar to those for insured loans with the possible exception of completion reports.

Loans on Savings Accounts. Associations are permitted to make loans to savers on the security of their savings accounts. The form of the notes will vary among associations; however, they will usually contain an assignment of collateral and a clause to the effect that the association has the right to withdraw from the savings accounts the loan amount due upon maturity or upon nonperformance of any terms of the notes. Assignment of the savings accounts as collateral may take the form of an executed restrictive withdrawal slip.

The collateral should be maintained under control since unrestricted access to the related passbooks or certificates may provide an opportunity for unauthorized withdrawals. It is also important that the individual savings accounts clearly designate the pledged status.

In addition to the auditing procedures applicable to loans in general as discussed in this chapter under "Auditing Loan Accounts," the independent auditor should review the method of granting loans on savings accounts and the nature of the internal accounting control in effect and make selective tests to determine that the account balance is sufficient to secure the loans.

Education Loans. Education loans are generally unsecured loans to students or their parents. Some of these loans are insured or guaranteed by governmental agencies and the applicable regulations should be reviewed. The accounting for these loans is similar to that for loans previously discussed and the auditing procedures discussed under "Auditing Loan Accounts" apply.

Mobile Homes. The FHLBB regulations permit associations to invest in purchase money financing and inventory financing of mobile homes. The collateral for such loans will usually be in the form of a chattel mortgage. The accounting for these loans is also similar to that for loans previously discussed and the auditing procedures discussed under "Auditing Loan Accounts" apply.

Loans Serviced by Others. Many associations own mortgage loans or participation interests therein which originated in distant areas. The loans or participations may have been purchased from other associations, savings or commercial banks, insurance companies or mortgage companies.

Auditing procedures which should be considered with respect to such loans and participations include a review of the minutes of board of directors' meetings for authorization, document inspection, confirmation of loan balances with borrowers, confirmation of balances due from other institutions, tests of transactions, and review of delinquent accounts. The independent auditor might, depending on the significance of amounts of such loans and participations, consider using one of the following methods for performing the audit tests deemed necessary in the circumstances:

1. Obtain from the servicing organization's own independent auditor a letter confirming the extent to which their examination included confirmation and other procedures with respect to such loans and the results; if deemed necessary, arrange to review the audit work papers of the servicing organization's independent auditors.
2. Engage the servicing organization's independent auditors or other local independent accountants to perform the confirmations and other tests on the basis of parameters established by the primary auditor; the timing of the examination of the client and the special work at the servicing organization should be considered so that the procedures applied can be reasonably concurrent.
3. Accept confirmation by the servicing organization itself in lieu of other procedures when the amounts are clearly not material and the servicing organization is a well-established organization (such as another large savings and loan association).

The independent auditor expressing an opinion on financial statements of an association must satisfy himself as to the adequacy of auditing procedures performed with respect to loans serviced by others.

Loans Serviced for Others. Although these loans are not assets of the association, the auditor must be satisfied as to their accountability including confirmation with the owner. The audit procedures with respect to the loans and participations, the advance payments for taxes and insurance, the cash accounts and the confirmation with borrowers are much the same as if the assets belonged to the association.

The independent auditor should be familiar with the audit requirements of the Federal Home Loan Mortgage Corporation and similar organizations in situations where an association is servicing loans for governmental agencies.

Sales of Loans or Participations. Savings and loan associations sometimes sell loans or a participation in loans. When entire loans are sold, the selling association may or may not continue to service the loans. When a participation in loans (i.e., an undivided interest in a loan or group of loans) is sold, the selling association frequently continues to service the loans. In either situation, the selling association may or may not be paid a fee for servicing the loans.

Gain or loss should be recognized at the time of sale of loans or participations. When loans are sold outright, and are not to be serviced by the selling association, the gain or loss is measured by the difference between the selling price and the face amount (less applicable deferred loan fees, if any) of the loans sold. If loans sold or loans included in a participation sold are to be serviced by the selling association, gain should be decreased and loss increased by the excess, if any, of estimated future servicing costs over estimated future servicing revenues, discounted to present value.

Because of the variety of arrangements under which participations are sold, it is important to consider the terms of sale, effective yield to the purchaser, and arrangements for servicing, in addition to the stated selling price. Premium or discount may result when a participation is sold at a price equal to the face amount of the loans included in the participation and the seller agrees to pay the purchaser a rate of interest greater or less than the stated rate of interest on the loans included in the participation. In such cases the premium or discount would be represented by the difference between the future interest to be collected by the seller and the interest to be paid to the purchaser, discounted to present value.

If all of the terms and arrangements relating to the sale have the effect of producing a premium or discount to the seller on the stated selling price, then in computing gain or loss on the transaction, the selling price should be increased by the amount of any premium or decreased by the amount of any discount. The offsetting debit or credit should be deferred and amortized in such a manner as to result in a constant rate of interest when applied to the uncollected balance at the beginning of any period.

The objectives in accounting for sales of loans or participations are to recognize in the year of sale any economic gain or loss from the transactions and to avoid including in the year of sale any income or expense attributable to future periods.

The principles and guidelines set forth in APB Opinion No. 21 apply with respect to determining the existence and amount of such premiums and discounts, the method of amortization, and statement presentation, and to the treatment of loans and participations sold prior to the effective date of the opinion.

Auditing Loan Accounts

Inspection of Documents. The extent of inspection of loan documents should be based on the independent auditor's evaluation of the association's internal control. A test of the files supporting old loans (loans made prior to the period covered by the current audit), as well as new loans, including some of the loans still in process, is generally needed to evaluate the association's controls and procedures. All of the documents relating to a particular loan usually are filed together in a separate folder for that loan.

Depending on the particular loan account being examined, the test inspection of documents supporting loans usually should comprise an examination, on a selective basis, of the applications, appraisal reports, notes, deeds of trust, mortgages or chattels, title insurance or opinion, insurance policies, settlement statements and VA guarantees or FHA insurance, if applicable. When such documents are in the hands of attorneys, escrow agents or others, the existence and ownership of the documents should be confirmed or the documents should be inspected. When documents are in the process of being recorded and are therefore not in the hands of the association or its attorneys, the independent auditor should satisfy himself that proper documents are subsequently received by the association.

The inspection of documents also should include tests, on a selective basis, of approvals by the board of directors or loan committee; tests of evidence (such as stamped loan documents) that mortgage documents have been entered on the public record; comparison of amount of loans with appraisals; inspection of any additional collateral indicated; and inspection, on a test basis, of the adequacy of hazard and title insurance coverage.

When loans are pledged as collateral for advances from the FHLB, associations, as trustees for the FHLB, are required to segregate and hold in separate files documents supporting pledged loans. A list of pledged loans should be compared, on a test basis, with the segregated files containing the loan documents and should be confirmed with the FHLB. When loans are pledged against borrowings from other banks, the loan documents may be in the hands of an association or a bank; in either case, confirmation should be obtained as to the pledge.

The independent auditor should not attempt to pass upon technical matters relating to loans, such as the value of collateral or the status of the title. He should satisfy himself, on a test basis, that opinions of appropriate experts are on file with respect to such matters. When questions arise concerning values or titles, the auditor should consult with, or request the opinion of, appropriate counsel or independent appraisers. See "Provision for Losses" on page 66.

Subsidiary Ledgers. Trial balances of the detail loan ledgers should be prepared by the independent auditor, obtained from the association and proved arithmetically, or prepared under the control of the independent auditor and reconciled with the general ledger control account. If prepared by the association, such trial balances should be test checked to the detail loan ledgers. The reconciliation of subsidiary or detail ledgers may be performed by an association's staff working under the control of the independent auditor. Control must be maintained over the ledgers until the reconciliation is complete in order to prevent improper adjustment of the accounts. If in the opinion of the independent auditor the internal control can be relied upon, the balancing of loan ledgers may be performed at a date other than the date of the statement of financial condition.

Delinquent Loans. The delinquent items shown in the subsidiary ledgers should be compared, on a test basis, to an "aged" list of delinquent balances and tests made to assure that all appropriate items are included. Delinquent loans frequently are an indication of potential losses, the exposure to which varies by type of loan. The independent auditor should consider such accounts, the association's collection procedures, loan modifications and other pertinent data in evaluating the reasonableness of the allowance for losses, if any, provided by the association.

See "Valuation Allowances and Treatment of Losses" on page 61 and "Provision for Losses" on page 66.

Entries for loans charged off should be reviewed to determine whether approval was given by the board of directors or the loan committee.

Confirmation of Loans. The balances of loans (including delinquent loans) should be confirmed to the extent the auditor deems appropriate. See discussion on pages 9 and 10.

Property Taxes, Assessments and Insurance. Inquiries should be made concerning the association's practice with regard to the payment of borrowers' property taxes, assessments and insurance, and its methods of determining whether these items are promptly paid and properly applied. The independent auditor should test the amounts provided by the borrower for taxes by referring to prior tax bills and current tax rates. See page 48 regarding advance payments from borrowers for taxes and insurance.

Accrued Interest Receivable on Loans

As stated in the first chapter, the accrual basis of accounting is the only acceptable basis under generally accepted accounting principles. Associations following the accrual method may include accrued interest income in the related loan balances or in a separate account designated "accrued interest income."

In instances where the cash basis is used, the independent auditor should be particularly attentive to the consistency with which the method of recording interest income has been applied as well as to the materiality of the amount of unrecorded interest income. If an association follows the practice of accounting for interest on the cash basis, the materiality of unrecorded accrued interest income in relation to the income statement and balance sheet should be considered. If the cash basis or modified cash basis is used, the independent auditor should evaluate the significance of the departure from generally accepted accounting principles and, if material, disclose the amount of such differences and modify his opinion appropriately.

Some associations schedule mortgage loan payments on the first day of the month, while others schedule monthly payments on other specified dates. Interest collected may be for the previous month or for the current month. The methods of recording interest for monthly amortization loans will not necessarily be the same as methods used for other loans. Further variations may be found with respect to loans serviced by others since some associations accrue interest which is expected from the servicer while others record the interest only as received from the servicer.

When the accrual method of recording interest income is used, an allowance for loss should be considered for uncollectible interest.

Interest income should be subjected to an overall arithmetical test or an arithmetical test of selected items. The overall test of interest income can be performed with relative ease if the association maintains controls for loans according to interest rates. In addition, the interest income accounts should be subjected to an analytical review for the period and comparisons made with the preceding year. Unusual changes or fluctuations should be investigated.

Undisbursed Portion of Mortgage Loans

Most associations carry one or more accounts labeled "Loans in process" which represent the undisbursed portion of mortgage loans which have already been recorded in full as association assets. The undisbursed portion of mortgage loans should be deducted from the related mortgage loans on the asset side of the statement of financial condition and the amount disclosed either on the face of the statement or in the notes to the financial statements.

Control accounts should be supported by subsidiary ledgers containing an individual account for the undisbursed portion of each mortgage loan. The aggregate of open balances in these subsidiary ledgers should be aged and balanced with the related controls. Debit balances (indicating overdrafts) and inactive accounts should be reviewed.

Since the principal amounts of the undisbursed portion of mortgage loans are carried as assets, confirmation requests with respect to such loans should include both the total amount of the loan and the undisbursed balance at the date confirmation is requested.

Tests should also be made of documents in the association's files which support disbursements charged to individual accounts, which in turn, support the undisbursed portion of mortgage loans. These tests should include loans completed or closed out during the period covered by the audit.

Loan Commitments

Loan commitments are not recorded in the accounts, but if the amounts of the commitments are significant in relation to the resources of the association, the total of commitments should be disclosed in the footnotes to the financial statements.

Most associations maintain current files of outstanding loan commitments; the auditor should review them and make such tests as he may consider appropriate in the circumstances.

Real Estate Owned

Real estate owned (REO) includes real estate acquired through foreclosure or by deed in lieu of foreclosure (foreclosed real estate) and real estate purchased for sale or development. It should not be confused with operating properties or with buildings and equipment used by the association in its business.

Associations are subject to limitations on amounts which may be invested in real estate to be held for sale or development. Although such investments are often immaterial in relation to total assets, the effect of possible losses, if any, may be significant in relation to total operations.

Management is responsible for establishing policies affecting the net carrying amount of REO. The independent auditor should obtain an understanding of management policies and the application of generally accepted accounting principles in determining the net carrying amount of REO. The independent auditor's examination should provide him with evidential matter supporting management's determination of net carrying amount of REO if he is to give his opinion on the financial statements without qualification. However, it may be necessary in some cases for the independent auditor to qualify his opinion or disclaim an opinion on the financial statements. The basis of carrying REO should be disclosed in the body of the financial statements or their footnotes.

Accounting for Real Estate Owned. REO should be recorded at the date acquired at the lower of cost or market value which is the acquisition cost for future measurement purposes. The cost of foreclosed real estate is the unpaid balance of the loan reduced by any related balances in loans in process and in deferred income plus the cost of securing title to and possession of the property reduced by any allowance for loss previously provided against the loan satisfied by the foreclosure. The latter costs would include foreclosure costs, advances for taxes and insurance, and unpaid property taxes which were a lien on the property at date of acquisition.

REO acquired through foreclosure or purchased for sale or development should be carried at the lower of cost or market. The principle of carrying REO at the lower of cost or market is generally accepted. In those cases where the cost of REO is greater than the market value at the date acquired, such excess should be charged to income as a loan loss or to an allowance for loan losses to the extent previously provided by charges to income. If subsequent to the date acquired the cost of REO is greater than the market value of the property, the carrying value should be reduced to market value by establishing an allowance for loss or by directly writing down the cost of the property by charges against income.

For the purpose of applying the principle of "lower of cost or market," "market" ordinarily means "current net selling price" except in those instances referred to below when it may be appropriate to use "estimated net realizable value." "Current net selling price" means the actual or expected price in cash or cash equivalents if sold currently, reduced by direct selling expenses such as sales commissions, advertising, cost of title policy, and other expenses of disposition.

"Estimated net realizable value" ordinarily would be used when current disposition is unlikely or when management intends to hold or develop over an extended period and generally should be limited to properties to be developed or in the process of development or construction. "Estimated net realizable value" means the estimated sales price in cash or cash equivalent upon subsequent disposition reduced by the sum of the following estimates: (1) direct selling expenses such as sales commissions; advertising, cost of title policy and other expenses of disposition;

(2) costs of completion or improvement; (3) direct holding costs during the projected holding period including taxes, maintenance and insurance (net of rental or other income); and (4) a discount factor to give effect to the cost of money, representing an allocation of interest expense for the period to the expected date of disposition.

Determination by management of estimated net realizable value and the measurement of estimated losses to be provided for involves many complexities. Each measurement involves assumptions as to future events and, when disposition of the property is projected some years into the future, the assumptions and projections exert significant influence on financial position and results of operations. Some of the important factors usually involved in determining estimated net realizable values are discussed below.

1. *Estimated sales price.* Usually this price is determined (a) by reference to comparable sales for cash or cash equivalents of individual units in the same development at approximately the same time, (b) by current offering price, (c) by reference to appraisals, or (d) by a combination of these approaches.
2. *Projected date of disposition.* The date of disposition often is within the control of management and may be extended or shortened to recognize their anticipation of the future condition of the real estate market or to recognize the need to improve or to complete construction of a project.
3. *Estimated costs of disposition.* These costs are often expressed as a percentage of the sales price.
4. *Estimated costs of improvement or completion.* These costs are involved typically in instances of unimproved and partially improved property and in instances of property needing rehabilitation.
5. *Estimated direct holding costs.* Since the properties under consideration are to be held or sold over an extended period of time, estimated net realizable value must include provision for taxes, maintenance, and other direct holding costs during the period to be held.
6. *Estimated cost of money (discount factor).* The estimated future sales price must be reduced by a factor to give effect to the cost of money during the period to be held.

The management of an association is responsible for evaluating all relevant factors, including those discussed above, and for determining the carrying value of REO and any allowance for losses. In the case of real estate acquired by foreclosure, the objective should be to recognize any loss in the year of foreclosure without the necessity of recognizing any loss upon disposition of the property in the future. In the discharge of this responsibility management may use the services of association appraisers, independent appraisers, or others.

Accounting for Direct Holding Costs and Discount Factor. Direct holding costs and amounts representing the cost of money invested in the property (discount factor) should be capitalized, subject to the lower of cost or market principle, when the current sale of REO is unlikely or when management intends to hold or develop property over an extended period. Capitalization of such costs may be accomplished in one of two ways: (1) by adding such costs directly to the carrying amount of the REO or (2) by charging such costs to a loss allowance to the extent they have been taken into account in establishing the allowance.

Much of the real estate acquired by foreclosure consists of scattered single family residences. Usually, the carrying amount of these properties will be based on lower of cost or current net selling price. This class of REO generally will be disposed of within a reasonably short period of time, such as six to eighteen months. For convenience, in such instances, associations generally charge direct holding costs, such as taxes and maintenance, to expense as incurred. Further, no adjustment is made for an amount representing the cost of money invested in the property. This Committee concurs in this accounting practice and believes that capitalization of direct holding costs or an amount representing the cost of money invested in the property under these circumstances would serve no useful purpose.

In some instances, which may involve substantial dollar amounts, the carrying amount of foreclosed property will be based upon the lower of cost or estimated net realizable value. Examples would include undeveloped land, partially developed land and partially developed tracts of single family residences. The computation of estimated net realizable value should include, among other items, provisions for direct holding costs and an amount representing the cost of money invested in the property.

To the extent that these items have been considered in computing estimated net realizable value, they should be capitalized or charged to the allowance for losses when incurred in subsequent periods.

If it is appropriate to charge direct holding costs and amounts representing the cost of money invested in the property to allowances provided therefor, then the same items should be capitalized on specific properties repossessed where no allowance for losses has been provided. However, the Committee has been informed that the matter of capitalization of interest is currently under study by the accounting profession and therefore is not taking a position on the appropriateness of capitalizing amounts representing cost of money applicable to REO on which no provision or allowance for loss has been provided. The Committee is of the opinion, however, that under no circumstances should the capitalization of holding costs or cost of money result in carrying REO in excess of market value.

Mr. Wall and Mr. Urich assent to publication of the guide with qualifications regarding (1) capitalization of holding costs (direct holding costs and cost of money) on foreclosed properties and (2) prohibition of changes which have the effect of reducing the amount initially provided for loss allowances on real estate owned.

On page 31, the guide requires capitalization of holding costs in one of two ways on certain properties held for sale. The guide also concurs in the practice of charging holding costs to expense, as incurred, on certain kinds of real estate owned. Thus, the effect on earnings in any period can be changed by using alternative appraisal techniques, even though either appraisal technique may result in substantially the same valuation. For example, an association with foreclosed property requiring no allowance for losses could either capitalize or expense future holding costs based solely on its optional use of a particular valuation technique, and could materially alter reported earnings with no change in basic facts.

The guide is inconsistent in that it requires capitalization of direct holding costs irrespective of whether a related loss allowance exists, when the estimated net realizable value appraisal technique is used. However, it permits capitalization of cost of money only to the extent that an allowance for loss has been provided. Thus, reported earnings can vary materially between years, dependent on the timing of costs incurred and the amount remaining in the allowance account at any time.

They believe that holding costs on foreclosed property are period costs and the accounting advocated by the guide is inappropriate, except where capitalization is appropriate during the construction period on real estate construction projects (subject to market value limitations).

Furthermore, Mr. Wall and Mr. Urich disagree with the guide's prohibition against changing loss allowances on real estate owned if the change would have the effect of reducing the amount initially provided (see page 36). Mr. Wall and Mr. Urich believe that such changes should be permitted, limited to the extent that net carrying amounts must not exceed cost at the time of foreclosure. The guide does not prohibit such changes in the allowance for loan losses, nor do generally accepted accounting principles prohibit such changes with respect to overall allowances for losses on receivables, marketable securities and certain other assets.

In summary, they believe that the important objective is to maintain adequate allowances for ultimate losses of both loans and properties acquired through foreclosure with the amount of such allowance determined as of the current reporting date, and not attempt to adjust the carrying value of such loans and properties by accounting for holding costs and allowances as recommended herein.

Tax Allocation of Direct Holding Costs and Discount Factor. To the extent direct holding costs and amounts representing the cost of money invested in the property (discount factor) are provided for and included in the allowance for loss charged to income, deferred taxes at current effective rates should be recognized by a credit to tax expense and a charge to a balance sheet deferred tax account (not applied as a reduction of the allowance for loss in the balance sheet). Such costs and amounts provided for and included in the allowance for loss should be separately identified in the accounting records.

In the periods in which interest and direct holding costs are capitalized, as discussed on page 31, but deducted for income tax purposes, the tax benefit realized should be credited to the balance sheet deferred tax account.

Upon sale of a property, any remaining deferred tax debit or credit in the balance sheet account would be charged or credited to deferred tax expense in the income statement.

Temporary Operations of Real Estate Owned. Net income or loss from operation of properties, after allowance for depreciation, ordinarily should be included in the statement of operations. Exceptions are permitted when the operations are insignificant in relation to the total cost of a property, as may be the case when a few scattered buildings, which are to be demolished, are rented on a tract of land to be developed, or when nominal crop operations are continued until construction begins. In cases of limited operations, any net income may be credited to the cost of the property and any net losses added to it, provided, in the latter case, that the carrying amount is not increased beyond estimated net realizable value.

Audit Procedures. The auditor is responsible for evaluating both management's determination of the carrying value of REO and the adequacy of the allowance for losses, if any. Usually the auditor will be able to document the factors involved in management's determination and to express an opinion on the financial statements as a whole. In some cases, however, uncertainties may be so great that he will be unable to form an opinion without qualification.

It may be appropriate for the independent auditor to make a test inspection of properties, observing the overall stage of completion of construction projects or the overall deterioration of completed properties held for sale, whether rented or not. However, the auditor must not put himself in a position of attempting to appraise property. In some instances he may need to seek corroboration by an independent appraiser; in others, he may be satisfied with data furnished him.

Appraisals are an essential factor in determining the net carrying amount of real estate owned. Appraisals by the association or by independent appraisers may be considered acceptable audit evidence. Appraisals are the products of work by people trained in appraisal principles and techniques. Quality of appraisals may vary, however, and in some instances the auditor may have reason to believe certain appraisals are unrealistic. Often he may be able to compare a particular appraisal with an appraisal of the same property by a state or federal regulatory body or he may have independent appraisals made of specific properties. While the independent auditor is not an appraiser, he should be aware that two, three or four independent appraisals on the same property may not give him any greater assurance as to the ultimate net realizable value than a single appraisal.

The independent auditor has the responsibility to investigate the basis of the appraisal reports and the factors used in them. Thus, if an appraiser has included direct holding costs and a discount factor, the auditor needs to know how much and for what period in order to relate the appraisal to estimated net realizable value. When direct holding costs or a discount factor have been omitted, the independent auditor should consider whether adjustments are necessary to arrive at estimated net realizable value.

If the auditor is unable to satisfy himself as to the reliability of appraisals, assumptions and projections utilized in the determination of the carrying value of REO and any related allowance for losses, he should disclose the matter in his report, with appropriate qualification or disclaimer of opinion.

The managements of certain associations will give greater emphasis to some factors than to others. Some managements may omit factors, or portions of them, in their determination of current net selling price or estimated net realizable value. Before he can form an opinion, the auditor should consider whether the variations or omissions are of such significance as to materially affect the determination of market in applying the principle of lower of cost or market. When factors such as direct holding costs or the discount factor are material and are omitted from the determination of estimated net realizable value, the auditor will need to evaluate whether a qualified or adverse opinion is required in his report.

At the conclusion of the audit, files of the auditor should support his conclusion as to the net carrying amount of real estate owned, showing the data and information relied on in his audit of this asset.

Allowances for Losses

The management of each association has the responsibility for establishing an adequate allowance for known or potential losses that may result from the collection of its loans or from the disposition of real estate owned. Provisions made for losses should be charged against income and the accumulated loss allowances should be deducted in financial statements from the related assets (see "Accounting for Real Estate Owned," page 29, and "Valuation Allowances and Treatment of Losses," page 61). Such allowances may include amounts not allocated to or identified with specific loans or properties. The independent auditor has the responsibility for evaluating the adequacy of allowances for losses and of reviewing the elements considered by management in making provisions for losses.

In evaluating the adequacy of allowances for losses on loans, the independent auditor should give consideration to delinquencies, evidence of the value of collateral, credit standing of the borrower, unusual economic conditions that may affect the collectibility of loans, and any other relevant information that may be pertinent in making his judgment as to the need for or adequacy of allowances for losses on loans.

The adequacy of allowances for losses on real estate owned depends both on the care and capability of an association's management in making the necessary calculations and on the probability that future events will occur as reasonably predicted.

The provision for losses with respect to individual properties is to be made at the time a loss is first indicated. The indication of loss often occurs at the time of foreclosure, but it may occur before or at some date after foreclosure. The provision should be made for the total loss expected and may involve appraisals, studies and projections of future events.

A provision for loss should be made for the excess of the acquisition cost of the property over the market value (current net selling price or estimated net realizable value). Continuing sizeable adjustments to increase the allowance for losses with respect to the same properties may indicate that an association is unable or unwilling to determine market value properly, or that changes have occurred in market conditions or in plans for disposal.

When REO has been written down to market value or an allowance for loss on REO has been established or increased subsequent to the date the property was acquired, such write-down should not be reduced or reversed or the allowance for loss reduced or reversed except upon the sale or other disposition of the property. However, if otherwise appropriate, additional costs incurred may be added to the carrying amount of REO, subject to the lower of cost or market principle.

With limited exceptions, anticipated gains on disposition of real estate should not be applied to offset potential losses in determining the allowance for losses. An example of an appropriate offset situation is when, in a tract of homes, expected losses on a house-by-house basis may be offset by expected gains on a house-by-house basis within that tract. In another situation, a bona fide sale of random properties to a single buyer shortly after the period under examination may permit all properties sold to that buyer to be considered as a unit and valued accordingly in determining the need for a provision for losses. In such a case, collateral must be aggregated and the buyer cannot default on one property and continue the loan on other property.

For offsets to be acceptable, some clear unitization of the separate properties is necessary.

An association alternatively may establish an allowance for losses on some general, overall basis, such as a percentage of loans made. This basis is not used frequently, however, since recent experience of associations shows little correlation between dollars loaned and dollars lost upon disposition of properties. Because losses tend to be highly individualistic in character, a statistical approach may be unworkable. Other bases for establishing an allowance for losses may be used and considered acceptable.

The most important objectives are to provide adequate allowances for ultimate losses upon final realization of loans and properties acquired through foreclosure and to charge the provision for losses to income of the proper accounting period.

Application of APB Opinion No. 20, "Accounting Changes." The initial application of methods of providing for holding costs and the subsequent capitalization of holding costs, as well as any subsequent changes in the association's method of determining the necessary loss provision on REO, is a change in accounting estimate as discussed in paragraph 11 of APB Opinion No. 20 and should therefore be accounted for in conformity with paragraph 31 of that Opinion.

Gains and Losses on Sale of Real Estate Owned

Generally, gains on the sale of real estate owned are recorded on the books of associations in compliance with supervisory requirements which may change from time to time. Present federal supervisory regulations provide that when loans are made to facilitate sales of real estate owned or a contract of sale is entered into, profits on the sales of such real estate not realized in cash must be deferred and recorded as income only to the extent that cash is received on the principal.

Paragraph 1, Chapter 1A of Accounting Research Bulletin No. 43, and APB Opinion No. 10 state that "profit is deemed to be realized when a sale in the ordinary course of business is effected, unless circumstances are such that the collection of the sale price is not reasonably assured." Further, see footnote 8 to APB Opinion No. 10 (as shown on the following page).

The Board recognizes that there are exceptional cases where receivables are collectible over an extended period of time and, because of the terms of the transactions or other conditions, there is no reasonable basis for estimating the degree of collectibility. When such circumstances exist, and as long as they exist, either the installment method or the cost recovery method of accounting may be used. (Under the cost recovery method, equal amounts of revenue and expense are recognized as collections are made until all costs have been recovered, postponing any recognition of profit until that time.)

In the absence of such circumstances, the accounting method presently prescribed by the federal regulations would be in conflict with generally accepted accounting principles. If the use of the method prescribed by the federal regulations results in a material difference from the method prescribed in ARB No. 43 and APB Opinion No. 10 and the circumstances would not permit the use of the installment or cost recovery methods, the independent auditor should issue a qualified or adverse opinion on the financial statements. (See the section on deferred income, page 56.)

The method followed by the association in recording gains on sales of real estate owned should be reviewed by the auditor for conformity with generally accepted accounting principles and for consistency of application. Tests should be made of the computation of any amounts carried as deferred credits and of amounts recorded as income during the period.

Losses incurred on sales of real estate owned should be charged against the allowance for losses to the extent that such a valuation allowance had been created by charges against income. The practice followed by many associations of charging such losses directly to supervisory loss reserves which were not created by charges against income is not in accordance with generally accepted accounting principles. Even though losses are charged to supervisory reserves in the association's accounts, such losses should be included as a charge in the statement of income. In some instances, a property may have been acquired and sold in the same accounting period and no allowance for loss may have been provided. In such an instance, associations frequently will charge the losses directly to an appropriately captioned expense account rather than to a valuation allowance. The auditor should investigate the practices followed by an association in accounting for losses on real estate owned and should consider whether adjustments are required. If unadjusted losses are material, the auditor should further consider whether the association's accounting treatment of these losses makes it necessary for him to issue a qualified or adverse opinion.

Gain or loss from the sale of real estate should be recognized at the time of sale and is measured by the difference between the carrying amount (reduced by any previously established allowance) and the selling price of the property. In some instances, the consideration received is represented wholly or partly by a note or other obligation of the purchaser and contains an effective rate of interest which is less than the cost of money or the interest rate on mortgage loans currently being made by the association on similar properties. Nonrecognition of an apparently small difference between the stated rate of interest and the applicable current rate may have a material effect on the financial statements if the face amount of the note is large and its term is relatively long. In these instances, such obligations should be accounted for in conformity with APB Opinion No. 21, "Interest on Receivables and Payables."

Real Estate Sold on Contract

Primarily to expedite the sale of real estate acquired by foreclosure, an association frequently is willing to sell the real estate with little or no initial payment required from the buyer or to sell to buyers who would not qualify for a conventional association loan because of credit or other reasons. Since the risk of default by the purchaser may be relatively great in such instances, documents are generally prepared in a manner that will permit the easiest reacquisition of the property by the association if a default occurs. Real estate sold on contract has most of the attributes of a conventional loan secured by real estate except that the association retains legal title to the real estate and conveys title to the purchaser only when the amount due under the contract has been paid.

The audit program should be similar to that outlined for mortgage loans, including reference to the authorization of the board of directors, inspection of documents, determination that title to the real estate is retained by the association, confirmation of balances, and review of collectibility. The auditor must exercise care in reviewing the collectibility of the balances as more than normal credit risk usually is present in this type of lending arrangement.

If large or unusual contracts of sale are involved, the auditor should consider field inspection to ascertain whether the properties show obvious signs of deterioration. When obvious conditions of deterioration appear, the independent auditor should consider the possible need for making or increasing the provisions for loan losses.

Reference should be made to the section on deferred income, page 56, for a discussion of the supervisory regulations with respect to unrealized profit on real estate sold.

Investments in Service Companies

A number of savings and loan associations have equity investments in subsidiary companies generally described as service corporations. The amount of investment in service corporations and the nature of activities in which a service corporation is permitted to engage are governed by rules and regulations of the FHLBB.

Service corporations may engage in a broad range of activities, some of which require approval by the FHLBB before being undertaken. These activities may involve rules and regulations of federal and state agencies in addition to those of the FHLBB and the FSLIC. The independent auditor should be familiar with the rules and regulations relating to investments in and activities of service corporations to the extent that noncompliance with these rules and regulations might materially affect the separate or consolidated financial position or results of operations of an association.

Management of an association and its independent auditors should give careful consideration to the need for presenting consolidated financial statements of an association and its subsidiary companies. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when an association directly or indirectly has a controlling financial interest in the subsidiary companies.[1]

[1] Accounting Research Bulletin No. 51, paragraph 1.

When the requisite control of subsidiary companies exists, consolidated financial statements of the association and its subsidiaries ordinarily should be presented. In the event consolidated financial statements are clearly inappropriate, the equity method should be used in accounting for investments in unconsolidated subsidiaries as set forth in APB Opinion No. 18. It should be noted, however, that the equity method is not a valid substitute for consolidation and should not be used to justify exclusion of a subsidiary when consolidation is otherwise appropriate.[2]

The management of an association having an investment in one or more subsidiary service corporations and the independent auditor also should be aware that the District Chief Examiner of each FHLB district has the responsibility and authority to reject a report as unacceptable if only separate financial statements of an association are furnished and the District Chief Examiner believes consolidated financial statements are necessary for fair presentation of financial position and results of operations.

Office Building, Equipment and Leasehold Improvements

The audit procedures with respect to these assets should be the same as those customarily followed in the audit of other commercial and industrial enterprises and would include the examination of appropriate documents in support of major additions and sales or retirements during the period under examination. Deeds and title insurance policies should be examined in support of major real property acquisitions. Evidence of insurance coverage should be obtained and reviewed in the light of present values and any co-insurance clauses contained in policies.

An investigation should be made of the association's policies with respect to capitalization, depreciation, repairs and maintenance, and obsolescence; the conformity of those policies with generally accepted accounting principles; and the consistency of their application in comparison with the preceding accounting period. The association's calculations of depreciation expense for the year should be checked, or appropriate tests made, and the total should be reconciled with charges to the association's operating accounts.

Appropriate information should be obtained with respect to

[2] APB Opinion No. 18, paragraph 14.

the total cost of any major expansion program and to the amount of any related commitments. Consideration should be given to the disclosure of commitments in the notes to the financial statements if amounts are material.

The auditor should determine compliance with federal and state regulatory requirements and restrictions concerning an association's investment in office buildings.

When association premises are leased from others, the leases should be examined. Pertinent lease information should be recorded in the work papers to support disclosures regarding long-term leases in notes to financial statements. Consideration should be given to compliance with APB Opinion No. 5 concerning lease information disclosure and possible capitalization of lease payments.

Safe Deposit Box Operations

An investigation should be made of the procedures used by the association in operating the deposit vaults. Insurance policies covering liabilities which might be incurred in the operation of these vaults should be examined for compliance with applicable laws and regulations.

Deferred Charges and Prepaid Expenses

Items in this category usually consist of prepaid FSLIC insurance premiums, other prepaid insurance, prepaid property taxes and other taxes, and prepayments into the secondary insurance reserve of the FSLIC.

Prepaid insurance premiums to the secondary reserve are the total of such payments made since 1961 as required by law, plus income earned on these payments by the FSLIC and added to the association's account, less the amounts used to pay the regular annual FSLIC insurance premiums.

These prepayments, together with those of all other insured associations, constitute a secondary reserve of the FSLIC for possible industry-wide losses of the FSLIC incident to its insurance of accounts. The FSLIC also maintains a primary reserve which must first be exhausted before the secondary reserve is charged with such losses.

Prepayments were required to be made annually until the combined primary and secondary reserves of the FSLIC reached 2 percent of the total insured depositor accounts. This first occurred in 1969. After once reaching the 2 percent level, transfers are made by the FSLIC from each association's secondary reserve account in payment of that association's regular annual premium, such transfers to continue until the combined secondary and primary reserves of the FSLIC fall below the specified percentage of the total accounts insured by the FSLIC. A transfer was made for the first time in 1970. When the combined industry-wide secondary and primary reserves on the books of the FSLIC decline to less than the specified percentage of the total accounts insured by the FSLIC, then each association must resume cash prepayments to the secondary reserve, the amount of each association's annual prepayment being measured as 2 percent of the increase in its savings account liabilities during the year, less the amount required to be paid for purchase of additional FHLBB stock. This prepayment and transfer pattern continues until the primary reserve alone on the books of the FSLIC reaches 2 percent of industry-wide insured accounts. When this occurs, the balance, if any, remaining in each association's individual secondary reserve account (after interim transfers to the primary reserve to pay regular premiums and after charges for FSLIC losses) will be refunded to such association in cash.

An association may otherwise realize on its prepayment account only by liquidation or termination of its insurance with the FSLIC, subject to certain conditions. Prepayment accounts may be transferred with regulatory approval in the event of merger or other combination of associations.

Proper classification of prepayments to the FSLIC secondary insurance reserve as asset or expense has been the subject of considerable discussion within the accounting profession and the savings and loan industry. It is the opinion of the Committee that such payments should be classified as assets for the following reasons:

1. Current law requires associations to pay insurance premiums to the FSLIC for a primary reserve.
2. Payments to the FSLIC secondary reserve are credited to the association's account. Accumulated amounts held by the

FSLIC to the credit of an association may be returned upon liquidation or voluntary withdrawal from the FSLIC, transferred upon merger or applied to primary reserve premiums.

3. The FSLIC annually credits to the association's account a return calculated at a rate equal to the average annual rate of return on the FSLIC's investment in U.S. Government obligations during the year ended the previous November 30. Associations record this credit as income and add a corresponding amount to the prepayment account.

Although the accumulated credits in an association's account can be utilized to meet losses in excess of the primary reserve, it currently appears remote that the primary reserve will soon be exhausted, thus requiring application of the secondary reserves to meet losses. The possibility of changing circumstances affecting the FSLIC secondary reserve will require independent auditors to review the status of this account during each examination.

The cumulative amount of the prepayments should be confirmed directly with the FSLIC, and the independent auditor should determine that the association's payments comply with existing regulations.

The audit procedures with respect to other deferred charges and prepaid assets should be comparable to those used in the audit of other commercial and industrial enterprises. These procedures include an examination of insurance policies and tax bills and a determination that the expenses are properly chargeable to future periods. The procedures should include a review of applicable expense accounts to ascertain that they do not include material amounts properly deferrable to future periods.

Other Assets

These commonly include accrued interest on investments, checks which a bank has refused to honor and miscellaneous accounts receivable. The independent auditor should examine appropriate evidence in support of the carrying value of the assets and should send confirmation requests when appropriate.

Some associations provide memorandum control accounts under this category for their supply of unissued travelers checks, money orders and savings bonds. Such items should be counted at the time of the cash count and confirmation obtained as to the association's accountability.

Savings Accounts

Savings accounts are the principal source of funds of savings and loan associations and generally savers are also members of the associations.

Passbook savings accounts historically have been the most predominant form of savings accounts; however, in recent years there has been a substantial increase in the use of a variety of savings certificates. Passbooks are generally issued to the savers for these accounts; additions, withdrawals and interest payments are entered in the passbook by the association. However, some associations furnish periodic statements of transactions in lieu of furnishing passbooks. Certificates for specified amounts are issued in various forms with varying maturities and interest rates as permitted by the rules and regulations governing associations. Associations often provide other special purpose accounts such as periodic savings accounts which are paid to the saver at the end of specific terms. These accounts would include Christmas club, investment club, and so forth.

Before beginning the examination of these accounts, the independent auditor should acquaint himself with the rules and regulations of the supervisory authorities and with the established policies and procedures of the association pertaining to savings accounts. Further, because of the volume of transactions and the significance of savings accounts in relation to the statement of financial condition the independent auditor should give particular attention to both the internal control relating to these accounts and the accounting procedures for recording transactions.

Individual records are maintained for each saver. These records frequently are in the form of an individual ledger card, but many records are maintained on electronic data processing equipment operated by the association or a service bureau. In any event, each account is assigned a number and, in addition to general ledger control accounts for the various classifications of savings, sub-control accounts are usually maintained for numerical or alphabetical groups within each major classification. Signature cards are usually filed alphabetically to facilitate cross referencing.

Generally, savings transactions are recorded initially by the use of teller window posting machines which simultaneously make an entry on a customer's passbook, when one is used. Several methods are used, however, to record the transaction on the customer's individual record maintained by the association. When the association maintains individual savings ledger cards, the cards and entries in the customers' passbooks may be posted simultaneously with the recording of transactions in the window posting machine. A variation of this method, known as "back office posting," permits an association to post savings cards at a later time using the primary documents (deposit slips and withdrawal slips) as the basis for the entries. Many associations have installed "on line" window posting machines which permit immediate entry of transactions into electronic data processing records.

Subsidiary Ledgers. Trial balances of the detail savings account ledgers should be prepared by the independent auditor or obtained from the association and proved arithmetically and reconciled with the general ledger control account. If prepared by the association, such trial balances should be test checked to the detail savings account ledgers. The reconciliation of subsidiary or detail ledgers may be performed by the association's staff working under the control of the independent auditor. Adequate control must be maintained over the ledgers until the reconciliation is completed in order to prevent improper adjustment of the accounts. If, in the opinion of the independent auditor, the internal control can be relied upon, the examination of savings accounts may be performed at a date other than the date of the statement of financial condition.

Confirmation of Savings Accounts. Confirmation of savings account balances (including certificate and bonus savings accounts) should be requested from savers on a test basis. Confirmation requests generally should be prepared as of the date selected for performing other auditing procedures with respect to savings account subsidiary ledgers. They should include a representative sample of active and inactive accounts, accounts which have been closed during the audit period, and large and unusual accounts. A general discussion of confirmations appears on page 9.

Investment Certificates. When an association issues investment certificates, tests should be made of certificate records and of cancelled certificates for the shares withdrawn during the audit period.

Bonus Accounts. An association may have bonus savings accounts on which interest over and above the rate on its regular accounts is paid if certain conditions are met by the saver. Tests should be made to ascertain that the specified conditions are being met and that the association is making the proper interest accrual.

Safekeeping for Members. When an association holds issued certificates and savings passbooks in safekeeping for members, the independent auditor should include such tests and confirmations as may be necessary in the circumstances, giving due weight to the effectiveness of applicable internal control procedures.

Pledged Savings Accounts. Savings accounts pledged as collateral for loans on savings accounts or as additional collateral for mortgage loans generally remain in the regular savings accounts control. Accounts pledged should be so designated and are thus restricted as to withdrawals.

Other. Additional tests may include (but are not limited to) review of the control over origination and access to signature cards; test of daily withdrawal slips to disbursement totals; the comparison of the withdrawal slips to the applicable ledger cards and signature cards; review of the control over origination and access to mailing address files; review of the control of mailing address files; review of the control of mail receipts; and tests to detect suppressed accounts.

Refer to page 65 for a discussion of interest paid on savings accounts.

Advances From Federal Home Loan Bank and Other Borrowed Money

Members of the FHLB System are permitted to borrow funds from the FHLB for expansion (funds to meet increased demand for loans) or for withdrawals (funds to meet unexpected withdrawals by savings account holders). These advances may be either short-term or long-term. The borrowing member's FHLB stock is pledged against all advances and generally a portion of the association's loan portfolio also is pledged. It is also possible that other assets may be pledged.

Borrowings also may be made from sources other than the FHLB on either a secured or an unsecured basis.

The legal limitations on borrowings from the FHLB are detailed in the *Rules and Regulations of the Federal Home Loan Bank System* and, in addition, such regulations limit the borrowings from other sources. The full borrowing power prescribed by those regulations is not normally available to an association—the available credit lines usually are determined by administrative policy pronouncements from the FHLBB. Further, the various FHLBs may control the credit lines of member associations on a case-by-case basis.

When loans are pledged as collateral to the FHLB, the association normally retains possession of the loan documents under a trust agreement with the FHLB. The FHLB frequently requests that the independent auditor report to them that these pledged loan documents exist, have been physically segregated from other loan documents, and have been examined by the independent auditor.

Confirmation of the terms and amounts of advances and other loans and related collateral should be obtained from the lender. It should be noted that the interest rate on borrowings from the FHLB may not be in agreement with the rate stated in the loan agreement because of rate adjustments by the FHLB.

Due Federal Reserve Bank for Savings Bonds Sold

The liability to the Federal Reserve Banks for Series E bonds sold should be reconciled with the inventory records and remittance reports submitted to the FRB. This should be done at the time the unissued and redeemed bonds on hand are counted in conjunction with the cash count as discussed previously. See "Confirmation" on page 9, and "Other Assets" on page 44.

Advance Payments From Borrowers for Taxes and Insurance

Many associations require borrowers to make monthly payments in addition to principal and interest in order to accumulate funds from which the association can pay property taxes and insurance premiums. The balances of these accounts are also referred to as "escrow accounts."

Trial balances of the detailed ledgers should be prepared by the independent auditor or obtained from the association and proved arithmetically and reconciled to the general ledger control account. If prepared by the association, such trial balances should be test checked to the detail ledgers.

Confirmation of these balances should be requested in conjunction with the confirmation of borrowers' loans. In this connection it may be necessary to furnish borrowers with the amounts paid by the association for insurance and taxes as shown by receipted invoices and tax bills. When there are any special legal requirements under contracts or statutes (such as for segregating the related cash or establishing trust funds), compliance with these requirements should be tested and the special funds and related liability separately identified in the association's balance sheet or disclosed in a note to the financial statements.

Unapplied Loan Collections

Under some systems, collections received on loans are credited to this account until the proper application is determined. The independent auditor should investigate the use of this account to ascertain that it is being properly maintained and, if material, the amounts should be applied against loans for financial statement purposes.

Income and Franchise Taxes Payable

In addition to the tax law applicable to corporations generally, special provisions are provided in Subchapter H of the U.S. Internal Revenue Code for savings and loan associations, provided the association meets certain definitional requirements contained in the Code. The most significant provision deals with the allowable bad debt addition and provides generally for a deduction in an amount equal to a percentage of taxable income (such percent decreases from 51 percent in 1972 to 40 percent in 1979), subject to certain limitations and requirements. This annual deduction permitted by the Code generally differs significantly from the bad debt experience upon which determination of pretax accounting income is based. Another significant provision treats real property acquired in settlement of loans as having the same character as the loan which it secured. Accordingly, the act of foreclosure is not a taxable event and the property is recorded at the adjusted basis of the loan. Provisions for estimated losses on loans and property acquired in settlement of loans, and any gains or losses on sales of such property are not included in the determination of taxable income but are charged or credited, as appropriate, to the accumulated bad debt reserves for tax purposes. Typically, savings and loan associations report on the cash basis of accounting for tax purposes but maintain their books and report to regulatory agencies and shareholders on the accrual basis.

Tax allocation required under APB Opinions, including APB Opinion No. 11, is applicable to savings and loan associations. The APB has determined in APB Opinion No. 23 that tax allocation is not required for the "difference between taxable income and pretax accounting income attributable to a bad debt reserve . . . ." Under these Opinions, the income tax provision should be based upon income used for financial reporting, adjusted to treat the provisions for estimated losses on loans and property acquired in settlement of loans, and gain or losses on sales of such property (except with respect to holding costs and discount factor as discussed on page 32) in accordance with the Internal Revenue Code.

In determining the amount on which tax allocation is not required, paragraph 21 of APB Opinion No. 23 defines certain terms. This paragraph reads as follows:

> The term pretax accounting income, as used in this section, represents income or loss for a period, exclusive of related income tax expense, determined in conformity with generally accepted accounting principles. The term taxable income, as used in this section, represents pretax accounting income (a) adjusted for reversal of provisions for estimated losses on loans and property acquired in settlement of loans, and gains or losses on the sales of such property, and adjusted for permanent differences, and (b) after giving effect to the bad debt deduction allowable by the United States Internal Revenue Code assuming the applicable tax return were to be prepared based on such adjusted pretax accounting income.

Paragraph 23 contains the following conclusion:

> The Board concludes that a difference between taxable income and pretax accounting income attributable to a bad debt reserve that is accounted for as part of the general reserves and undivided profits of a savings and loan association may not reverse until indefinite future periods or may never reverse. The association controls the events that create the tax consequence, and the association is required to take specific action before the initial difference reverses. Therefore, a savings and loan association should not provide income taxes on this difference. However, if circumstances indicate that the association is likely to pay income taxes, either currently or in later years, because of known or expected reductions in the bad debt reserve, income taxes attributable to that reduction should be accrued as tax expense of the current period; the accrual of those income taxes should not be accounted for as an extraordinary item.

The independent auditor should review computations of income and franchise tax accruals. He should be familiar with the specific provisions of federal, state and local revenue laws and regulations affecting savings and loan associations. His review should include the following steps:

1. Ascertain whether the association complies with all of the definitional requirements of the Internal Revenue Code to receive the specialized tax treatment accorded a savings and loan association.
2. Ascertain whether the amounts of any permanent differences, including provision for estimated losses on loans and property acquired in settlement of loans, and gains or losses on the sales of such property have been determined properly.
3. Ascertain whether the bad debt deduction has been computed properly by multiplying the current percentage provided in the Internal Revenue Code times adjusted pretax accounting income (as defined in paragraph 21 of APB Opinion No. 23).
4. Ascertain whether the bad debt deduction so computed is not in excess of either the current 6 percent limitation, which is based on loans outstanding at the end of the year, or the current 12 percent limitation, which is based upon end of the year aggregate savings account balances. For this purpose

the accumulated balance of the bad debt reserves should have been calculated as if all tax returns for the association were prepared based on adjusted pretax accounting income.

5. Ascertain whether provision has been made for any adjustments resulting from examinations of tax returns by taxing authorities.
6. Review the segregation of the income tax expense between current and deferred income taxes.

Application of Paragraph 21 of APB Opinion No. 23. The application of paragraph 21 of APB Opinion No. 23 is illustrated by the example on the following page. The column "Federal Income Tax Return" is presented to illustrate the difference, resulting from timing differences, between the bad debt deduction computed under the provisions of APB Opinion No. 23 and the deduction allowable on the federal income tax return.

Reconciliation of "Pretax Accounting Income" to "Taxable Income"

	Financial Statements	*Federal Income Tax Return*
Income per financial statements, before income taxes (Pretax accounting income)	$800,000	$800,000
Adjustments:		
Provision for losses on loans and property acquired in settlement of loans	60,000	60,000
Gain on sale of property acquired in settlement of loans	(25,000)	(25,000)
Other permanent differences:		
Officers' life insurance premiums	3,000	3,000
Municipal bond interest	(35,000)	(35,000)
Unallowable deductions	2,000	2,000
Dividends on pre-1942 FHLB stock	(1,000)	(1,000)
Timing differences:		
Accelerated depreciation	—	(25,000)
Loan fees	—	75,000
Adjusted pretax accounting income	804,000	
(Taxable income before bad debt deduction)		854,000
Bad debt deduction (51% thereof)	410,040	435,540
Taxable income	$393,960	
(Taxable income per federal income tax return)		$418,460
Tax thereon (assumed 50% rate and use of "net change" basis)	$196,980	$209,230

Under paragraph 23 of APB Opinion No. 23 the association would not be required to provide income taxes on the difference of $410,040 between "taxable income" and "adjusted pretax accounting income." In this illustration, the current year's tax provision would be $196,980, of which $209,230 would be currently payable and the difference of $12,250, relating to timing differences, deferred either as a prepaid tax or reduction of deferred taxes previously provided.

If, in the above example, the cumulative bad debt reserve balance on "qualifying real property loans" (QLR), as defined by the United States Internal Revenue Code, was such that the $410,040 bad debt deduction would cause the balance of the reserve to exceed the 6% limitation based upon total qualifying real property loans outstanding at year end, then "taxable income" would be computed as shown on the following two pages.

	Financial Statements			Federal Income Tax Return		
Adjusted pretax accounting income (from above)			$804,000			
(Taxable income before bad debt deduction—from above)						$854,000
Qualifying Real Property loans at year end		$41,580,000			$41,580,000	
Six percent thereof		2,494,800			2,494,800	
Cumulative balance of QLR (the difference between the balance for book and tax purposes represents the cumulative effect of prior timing differences)	$2,385,800			$2,000,000		
Adjustments: (from above)						
Provision for losses on loans and property acquired in settlement of loans	(60,000)			(60,000)		
Gain on sale of property acquired in settlement of qualifying real property loans (net)	25,000			25,000		

Adjusted balance of QLR	2,350,800		1,965,000	
Bad debt deduction (51% of adjusted pretax accounting income [taxable income before bad debt deduction for federal income tax return], limited to amount which increases adjusted balance of QLR to 6% of qualifying real property loans at year end)		144,000		435,540
Taxable income		$660,000		
(Taxable income per federal income tax return)				$418,460
Tax thereon (assumed 50% rate and use of "net change" basis)		$330,000		$209,230

In this illustration, under paragraph 23, the association would not be required to provide income taxes on the $144,000 difference. The current year's tax provision would be $330,000, of which $209,230 would be currently payable and the balance of $120,770, which relates to (1) the tax effect of timing differences and (2) reaching the 6 percent limitation on the bad debt reserve on the financial statement basis prior to reaching the limitation on the tax return basis, would be deferred.

Applicability of Accounting Principles Board Opinion No. 23 to General Reserve Appropriations. Paragraphs 24 and 25 of Opinion No. 23 read as follows:

> 24. *Disclosure.* Information that should be disclosed in notes to financial statements of a savings and loan association concerning bad debt reserves that are accounted for as part of the general reserves and undivided profits includes:
> a. The purposes for which the reserves are provided under the applicable rules and regulations and the fact that income taxes may be payable if the reserves are used for other purposes, and
> b. The accumulated amount of the reserves for which income taxes have not been accrued.
>
> 25. The disclosure requirements set forth in paragraph 24 also apply to a parent company of a savings and loan association accounting for that investment either through consolidation or by the equity method.

Other Liabilities

The accounts classified as other liabilities comprise accrued expenses and other items not specifically included in the liability accounts discussed above. The audit procedures are similar to those followed in audits of other commercial and industrial enterprises.

Deferred Income

In compliance with regulatory requirements, certain income items are deferred and amortized over future periods. The independent auditor should be alert to the possibility that deferred income accounts established to conform to regulations of the FHLBB may be in conflict with generally accepted accounting principles. When deferral methods are in conflict with APB Opinions and have a material effect on the financial statements, the independent auditor must issue a qualified or adverse opinion on the financial statements.

Some of the items usually deferred under present supervisory regulations are as follows:

1. *Unrealized profit on real estate sold.* When a loan is made to facilitate the sale of real estate owned, federal regulations require that profit on the sale, which is not received in cash,

shall be deferred and recorded as income to the extent principal payments are received. See "Gains and Losses on Sale of Real Estate Owned" beginning on page 37.

2. *Gains or losses on security transactions.* Federal regulations provide that, as an alternative to recognizing such gains and losses when realized, an association could, during 1970 and 1971, elect to defer and amortize all gains and losses (net of related taxes) resulting from the disposition of any securities if such disposition is part of a plan adopted for the purpose of meeting liquidity requirements and is consistently followed with respect to all such transactions. See "Investments in Securities" beginning on page 15.
3. *Interest earned but uncollected.* Associations may charge accrued interest to loan accounts but in some states must defer 100 percent of the accrual. See "Accrued Interest Receivable on Loans" beginning on page 26.
4. *Unearned loan fees and loan fees collected in advance.* These are loan and commitment fees in excess of those which may be taken directly as income as defined in the FSLIC regulations.
5. *Unearned discounts on purchased loans.* Present federal regulations require that these discounts be deferred and amortized over a specified period.
6. *Unearned discount on home improvement loans.* Interest is added to the principal of the original loan and is amortized over the life of the loan.

The accounting treatment described in the items above may be in conflict with generally accepted accounting principles, although results of such treatment in some instances may not be materially different than if generally accepted accounting principles were followed.

Loan fees which represent "points" or yield adjustments and commitment fees, in excess of loan acquisition or origination costs, should be deferred and amortized over future periods. Generally, fees related to construction loans should be segregated from those relating to long-term mortgage loans. With respect to loan fees resulting from transactions entered into after December 31, 1971, the method of amortization should result in a substantially constant yield over the expected term of the related loans or alternatively over the estimated composite life of all loans of a similar class in the loan portfolio. Unamortized loan fees and commitment fees included in the face of the loan should be shown separately as a deduction from the related loans in the statement of financial condition.

Unearned discounts on purchased loans and unearned interest and finance charges included in the face amount of loans should be amortized on an interest method over the expected term of the related loans, and the unamortized balance should be shown separately as a deduction from the related loans in the statement of financial condition.

Interest on loans is sometimes paid in advance by the borrower or it may be deducted by the association from loan proceeds. Such amounts should be deferred and reported as income as the interest is earned.

Tests should be made of the computation of amounts deferred and amounts recorded as income during the period. Consideration should be given as to whether any class or item of recorded income should be deferred.

Capital Stock

Approximately twenty states provide for capital stock associations, i.e., associations which are authorized by state charter to issue and sell capital stock (called permanent reserve shares, guaranty stock or guarantee stock) to investors.

The auditing procedures in connection with capital stock issued by a savings and loan association are generally the same as for any other corporation.

Some associations may from time to time issue stock dividends to their investors. Unless the stock is closely held, generally accepted accounting principles require that such stock dividends be recorded at fair market value in compliance with ARB No. 43, Chapter 7, Section B. However, state supervisory authorities may prohibit recognizing any amount on the books in excess of par value or the book value of the stock at the time issued.

A reporting problem arises where the fair market value of the stock dividend is recorded on the books. In such a case the cumulative fair market value of stock dividends issued generally exceeds the balance available in unappropriated retained income. Since this amount cannot be charged to general reserves because of supervisory restrictions, various methods of presentation in the equity section of the statement of condition may be found. One such method, commonly referred to as the "dangling debit," reflects the entire cumulative amount of the market value of stock dividends as a separate charge in the retained income section without relating the item specifically to other accounts. The offsetting credit for the par value goes to the capital stock account and the credit for any excess goes to capital surplus. The Committee believes that the "dangling debit" treatment is appropriate until the matter of accounting for stockholders' equity is modified or revised by the Accounting Principles Board.

General Reserves (Appropriated Retained Income)

Nature of General Reserves. The term "general reserves" refers to the aggregate amount of reserves established by an association for the sole purpose of absorbing losses but does not include valuation allowances. Usually, the general reserves have been established by appropriations of net income. Additions are made through semiannual or annual appropriations of earnings or undivided profits in accordance with rules and regulations of federal and state supervisory authorities. In a broad sense, "general reserves" may encompass one or more accounts of an association usually described as follows:

- General reserve
- Federal insurance reserve
- Reserve for contingencies
- Legal reserve
- Reserve for bad debts

While general reserves are, in accordance with supervisory rules and regulations, provided to "absorb losses," they comprise a part of the equity or net worth of an association and accordingly should not be substituted for valuation allowances. Valuation allowances, when required, must be deducted from the specific assets to which they apply and should not be confused with general reserves.

Supervisory Reserves. Federal associations are required to maintain a "federal insurance reserve" or a "reserve for contingencies" or other optionally named reserves for the sole purpose of absorbing losses in accordance with requirements of the *Rules and Regulations for the Federal Savings and Loan System* and the *Rules and Regulations for Insurance of Accounts.*

State-chartered associations insured by the FSLIC must maintain a federal insurance reserve in accordance with *Rules and Regulations for Insurance of Accounts* and must also meet the requirements of any state regulations requiring the maintenance of reserves. Frequently, reserves established to meet the requirements of federal regulations will be adequate, if appropriately designated, to meet the requirements of state reserve regulations.

The charters of some associations may contain provisions relating to reserve requirements. In some special situations, agreements with or restrictions imposed by supervisory authorities may affect reserve requirements.

Income Tax Reserve for Bad Debts. If a savings and loan association meets certain special tests and limitations provided in the Internal Revenue Code, deductions from taxable income are permitted for annual additions to a reserve for bad debts computed in accordance with special provisions of the Code. The special tests provided in the Code and federal income tax regulations pertain principally to investments in qualifying assets, and to the percentage of qualifying gross income to total gross income. For federal income tax purposes, the reserve for bad debts need not be separately identified in financial statements and may be greater or less than the supervisory reserves described above. In any event, an association must comply with both the supervisory regulations governing the general reserves and the Internal Revenue Code and the related regulations governing the income tax reserve for bad debts.

As discussed on page 62, the Accounting Principles Board has concluded in APB Opinion No. 23 that tax allocation is not required for the difference between taxable income and pretax accounting income attributable to a bad debt reserve that is accounted for as part of the general reserves and undivided profits of a savings and loan association, except in certain circumstances. If circumstances indicate that the association is likely to pay income taxes, either currently or in later years, because of known or expected reductions in the bad debt reserve, income taxes attributable to that reduction should be accrued as tax expense of the current period; the accrual of those income taxes should not be accounted for as an extraordinary item.

In considering the likelihood of payment of income taxes because of reductions in reserves (other than from bad debt losses charged to the reserves), consideration should be given as to whether the association is likely to take any action which will create a tax liability and whether under existing rules and regulations, supervisory authorities will permit the use of such reserves for purposes which will create a tax liability for the association. Such consideration would apply to both capital stock and mutual associations, although, with rare exceptions (e.g., liquidations), distributions by mutual associations to their members are deductible for tax purposes and it is unlikely that any future income tax would become payable as a result of the use of general reserves for this purpose.

Financial Statement Presentation. In financial statements, general reserves and appropriations thereto (in excess of amounts charged against income to provide for valuation allowances for losses in determining net income) should be dealt with in accordance with the provisions of Chapter 6 of ARB No. 43 relating to contingency reserves. Accordingly, in the statement of financial condition the general reserves would be shown in the equity section and the descriptive captions would indicate that these reserves are appropriated retained income.

The basic financial statements of an association include a statement of retained income or stockholders' equity, which is frequently presented in columnar form as part of a combined statement including general reserves and retained income (undivided profits).

Valuation Allowances and Treatment of Losses

Federal and some state supervisory rules and regulations permit an association to charge losses directly to general reserves which were created by appropriations of net income rather than by charges against current earnings. However, under generally accepted accounting principles, losses or provisions for losses (determined in accordance with these principles) should be reflected as a charge in arriving at net income in the statement of income.

In the preparation of financial statements, it is common practice when losses have been charged directly to general reserves on the books of the association to reclassify such losses as a charge against current earnings. This procedure generally eliminates the necessity for qualification of the accountant's opinion.

Loss allowances accumulated through charges in arriving at net income should be deducted from the related assets in the statement of financial condition.

Tax Allocation—Book versus Regulatory Provision for Bad Debts. The Accounting Principles Board published Opinion No. 23, "Accounting for Income Taxes—Special Areas," in April 1972. One of the special areas considered in that Opinion was "'Bad Debt Reserves' of Savings and Loan Associations." Consideration of the subject and the conclusion of the Board on tax allocation of the difference between book and required regulatory provisions for bad debt losses follows.

"BAD DEBT RESERVES" OF SAVINGS AND LOAN ASSOCIATIONS

Discussion

19. Regulatory authorities require both stock and mutual savings and loan associations to appropriate a portion of earnings to general reserves[8] and to retain the reserves as a protection for depositors. Provisions of the United States Internal Revenue Code permit a savings and loan association to deduct an annual addition to a reserve for bad debts[8] in determining taxable income, subject to certain limitations. This annual addition permitted by the Code generally differs significantly from the bad debt experience upon which determination of pretax accounting income is based. Thus, taxable income and pretax accounting income of an association usually differ.

20. Although a general reserve determined according to requirements of the regulatory authorities is not directly related to a reserve for bad debts computed according to provisions of the United States Internal Revenue Code, the purposes and restrictions of each reserve are similar. Amounts of bad debt deductions for income tax purposes are includable in taxable income of later years only if the bad debt reserves are used subsequently for purposes other than to absorb bad debt losses.

21. The term *pretax accounting income*, as used in this section, represents income or loss for a period, exclusive of related

[8] The terms *general reserves* and *reserve for bad debts* are used in the context of the special meaning these terms have in regulatory pronouncements and in the United States Internal Revenue Code.

income tax expense, determined in conformity with generally accepted accounting principles. The term *taxable income,* as used in this section, represents pretax accounting income (a) adjusted for reversal of provisions for estimated losses on loans and property acquired in settlement of loans, and gains or losses on the sales of such property, and adjusted for permanent differences, and (b) after giving effect to the bad debt deduction allowable by the United States Internal Revenue Code assuming the applicable tax return were to be prepared based on such adjusted pretax accounting income.

22. Some believe that a difference between taxable income and pretax accounting income attributable to a bad debt reserve that is accounted for as part of the general reserve and undivided profits of a savings and loan association has attributes of a permanent or indefinite deferral of tax payments. In their view, a savings and loan association should not accrue income taxes on such differences. Others believe that this difference has the principal attributes of a timing difference as described in paragraphs 36 and 37 of APB Opinion No. 11. In effect, they believe that this difference is a Government-sponsored deferral of tax, that the Government has an equity in the savings and loan association to the extent of the deferred tax, and that it is inappropriate to include earnings in stockholders' equity without accruing income taxes which the association would incur if the earnings were distributed to stockholders or otherwise became subject to tax. In their view the savings and loan association should recognize deferred taxes on the difference.

Opinion

23. The Board concludes that a difference between taxable income and pretax accounting income attributable to a bad debt reserve that is accounted for as part of the general reserves and undivided profits of a savings and loan association[9] may not reverse until indefinite future periods or may never reverse. The association controls the events that create the tax consequence, and the association is required to take specific action before the initial difference reverses. Therefore, a savings and loan association should not provide income taxes on this difference. How-

[9] Paragraph 38 of APB Opinion No. 11 indicated that the "general reserves" of stock savings and loan associations was a special area requiring further study. In practice the statement also has been applied to mutual savings and loan associations and mutual savings banks. The Board affirms that its conclusions in this Opinion apply to stock and mutual savings and loan associations and mutual savings banks.

ever, if circumstances indicate that the association is likely to pay income taxes, either currently or in later years, because of known or expected reductions in the bad debt reserve, income taxes attributable to that reduction should be accrued as tax expense of the current period; the accrual of those income taxes should not be accounted for as an extraordinary item.

24. *Disclosure.* Information that should be disclosed in notes to financial statements of a savings and loan association concerning bad debt reserves that are accounted for as part of the general reserves and undivided profits includes:

a. The purposes for which the reserves are provided under the applicable rules and regulations and the fact that income taxes may be payable if the reserves are used for other purposes, and

b. The accumulated amount of the reserves for which income taxes have not been accrued.[10]

25. The disclosure requirements set forth in paragraph 24 also apply to a parent company of a savings and loan association accounting for that investment either through consolidation or by the equity method.

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[10] Other disclosure requirements in paragraphs 56-64 of APB Opinion No. 11 may also apply.

Audit Considerations. The independent auditor should become familiar with the reserve requirements of the association's charter and either the appropriate state regulations or the *Rules and Regulations for the Federal Savings and Loan System.* With respect to all associations insured by the FSLIC, the auditor should also consider the applicable requirements of the *Rules and Regulations for Insurance of Accounts.*

He should also be familiar with the special provisions of federal, state, and local tax laws affecting the reserves of savings and loan associations.

The independent auditor should review the general reserves for compliance with the rules and regulations and should consider whether disclosure should be made of any deviations. The independent auditor should also consider whether such deviations should be discussed with the supervisory agent and the Chief Examiner. With respect to capital stock associations, he should ordinarily obtain written representations from management to the effect that no action has been taken nor is any action contemplated which would cause any portion of the general reserves to be subject to income tax.

Unappropriated Retained Income

Unappropriated retained income (frequently called undivided profits in the accounts of mutual associations) represents the undistributed and unappropriated income of the association retained for general corporate use.

The financial statements should disclose any significant restrictions on the use of unappropriated retained income for the payment of dividends. These restrictions would include absolute restrictions, such as those imposed by state laws or credit agreements and those restrictions resulting from any additional income tax requirement before payment of dividends.

Income

Principal sources of income generally include interest on loans, origination loan fees, other loan fees and service charges, income on investments, insurance commissions, escrow and trustee fees, rentals from real estate owned (including foreclosed property and office buildings) and gains on sale of real estate. Other sources of income may include appraisal fees, membership and transfer fees, fines, rental of safe deposit boxes, etc. An association's policies with respect to recording income should be determined and sufficient tests made to ascertain that these policies are being consistently applied and that they are in accordance with generally accepted accounting principles.

Any material fluctuations in income should be investigated and satisfactory explanations obtained.

Expenses

Interest on Savings Accounts. Interest paid or credited on individual savings accounts during the audit period should be tested for proper computation and recording in the accounts. In addition, an overall test should be made of the total interest paid or credited during the period.

The independent auditor must ascertain the date to which interest on savings accounts has been recorded on the books of the association. When this date does not coincide with the audit date, an adjustment for statement purposes would be appropriate if the amount is material. Otherwise, it may be necessary for the auditor to qualify his opinion or give an adverse opinion as to the financial statements, especially if the income statement is for a short period.

Other Expenses. The examination of other expenses should be substantially the same as the procedures followed in other industries, performed in accordance with generally accepted auditing standards to enable the expression of an opinion as to the fair presentation of financial data.

Provision for Losses

Loans receivable and real estate owned must be reviewed to determine that the association has made an adequate provision for estimated losses, if any. Generally accepted accounting principles require that loss provisions be reported as a charge in determining net income and that the accumulated allowance for such losses be deducted from the related asset. See "Valuation Allowances and Treatment of Losses" on page 61. If such losses are charged directly to general reserves, as generally permitted by federal and state rules and regulations, the independent auditor may be required to take exception to this practice in his report unless the losses are reclassified in financial statements in accordance with generally accepted accounting principles.

Reference is made to "Real Estate Owned," page 28, for a discussion of the factors to be considered in determining the adequacy of the provision for losses.

Accounting for Business Combinations of Associations

Principles of accounting for combinations of business corporations generally and guides for application of these principles are set forth in APB Opinion No. 16. Since capital stock savings and loan associations possess the relevant characteristics of other business corporations, this Opinion is equally applicable to business combinations of capital stock associations.

The Committee believes the principles of this Opinion also should be applied as a general guide to combinations of two or more mutual associations or of a capital stock association and one or more mutual associations.[1] Although mutual associations have no capital stock, the holders of savings accounts may be regarded as having a form of equity interest in these associations. Therefore, if a merger or other combination involving one or more mutual associations meets the conditions (other than those pertaining to stock ownership) set forth in paragraphs 46 to 48 of APB Opinion No. 16, the combination should be accounted for on the pooling of interests method; all other combinations should be accounted for by the purchase method as described in paragraphs 66 to 96 of APB Opinion No. 16.

[1] In paragraph 5 of APB Opinion No. 16, it is stated that the Opinion does not discuss the combination of a corporation and one or more unincorporated businesses or of two or more unincorporated businesses, but its provisions should be applied as a general guide. In addition, the Opinion does not discuss combinations of business corporations not having capital stock.

Reporting

The Independent Auditor's Report

The independent auditor reporting on the financial statements of savings and loan associations is governed by the same generally accepted auditing standards which apply to the financial statements of companies in other industries. These standards are described in Statements on Auditing Procedure issued by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants.

Insured associations are subject to accounting rules prescribed by the FHLBB under the *Rules and Regulations for Insurance of Accounts*. Thus, the independent auditor occasionally may encounter accounting requirements which are at variance with generally accepted accounting principles. In view of this, special attention is directed to Chapter 10, paragraphs 38 through 40 of SAP No. 33 which deals with reporting on regulated companies. Some of the more common variances which may be encountered stem from the accounting requirements, as previously discussed, for items such as:

1. The amortization of premiums or discounts on loans.
2. Real estate owned.
3. Recording of profits or losses from the sale of real estate owned.
4. Gains or losses on security transactions.
5. Deferral of loan fees.

6. The provision for losses on loans.
7. Distribution of stock dividends.

Where variances from generally accepted accounting principles are material in amount, the independent auditor must use judgment in determining if a qualification of opinion is sufficient or if the departure variances are so material that an adverse opinion is more appropriate. In either case, the opinion should specifically refer to the variance and should give a clear explanation of the nature of the qualification and the effect of the variance on financial condition and results of operations.

The FHLBB Statement of Policy Concerning Acceptability of Auditors and Audits and its PA Bulletins state the FHLBB requirements for audits of savings and loan associations. With respect to audit reports, the bulletins provide that the auditor should make reference to any separate report to the association's board of directors regarding internal control. An illustration of the auditor's report is included in the illustrative financial statements.

An illustration of a letter commenting on an association's internal control appears on page 93.

Other specific audit requirements of the FHLBB pertaining to the scope of the audit and the independent auditor's report are similar to those required under generally accepted auditing standards and are therefore not discussed in this guide.

Illustrative Financial Statements for:

A Mutual Association
A Stock Association

The following illustrative financial statements of a mutual association and a stock association reflect the practices described in the foregoing chapters. The Committee considers the format of the illustrative statements appropriate for presenting the basic financial statements for savings and loan associations.

A Mutual Association

To the Directors of the CSM Mutual
Savings and Loan Association

We have examined the statement of financial condition of CSM Mutual Savings and Loan Association as of September 30, 1971, and the related statements of income, retained income and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying statements present fairly the financial position of CSM Mutual Savings and Loan Association at September 30, 1971, and the results of its operations and changes in financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Signature

City, State
Date

NOTE: Present requirements of FHLBB Bulletin PA-6 provide that when comments relative to the system of internal control are presented to management in a separate report, the report of audit should contain a reference to such other report. Accordingly, the following paragraph is illustrative of a means of responding to this requirement in reports to be filed with the District Chief Examiner of the FHLBB; the paragraph should not be included in published reports or reports for other purposes.

> Our comments relative to the system of internal control have been (will be) submitted separately to the Association's Board of Directors.

CSM Mutual Savings and

Statement of

September 30,

Assets	*1971*	*1970*
Cash	$ 425,000	$ 396,500
U.S. Government obligations, at amortized cost (approximate market 1971 $890,000) (Note 2)	975,000	1,073,000
Other investments, at cost	82,500	75,000
Loans receivable, net (Notes 1 and 3)	19,141,450	17,395,405
Accrued interest receivable	186,000	159,000
Real estate owned, at cost, less allowance for losses of $76,500 in 1971 and $65,000 in 1970	735,000	718,300
Federal Home Loan Bank Stock, at cost (Note 3)	240,000	215,500
Office properties and equipment, at cost, less accumulated depreciation of $235,000 in 1971 and $190,000 in 1970 (Notes 4 and 8)	1,265,000	1,302,500
Prepayments to FSLIC secondary reserve	255,000	223,800
Prepaid expenses and other assets	11,500	16,400
Total Assets	$23,316,450	$21,575,405

See Notes to Financial Statements.

Loan Association

Financial Condition

1971 and 1970

Liabilities and Retained Income	*1971*	*1970*
Liabilities:		
Savings accounts	$20,000,000	$18,250,000
Notes payable (Note 2)	105,000	90,000
Advances from Federal Home Loan Bank (Note 3)	475,000	675,000
Accrued interest payable	237,600	223,155
Advances by borrowers for taxes and insurance	176,500	161,735
Accounts payable and accrued expenses	17,900	11,400
Federal and state income taxes (Note 6)	21,150	12,415
Deferred income taxes (Note 8)	72,800	54,600
Total Liabilities	21,105,950	19,478,305
Retained income (Note 5):		
Appropriated to general reserves	1,427,700	1,379,500
Unappropriated	782,800	717,600
Total Retained Income	2,210,500	2,097,100
Total Liabilities and Retained Income	$23,316,450	$21,575,405

CSM Mutual Savings and Loan Association
Statement of Income

Years Ended September 30, 1971 and 1970

	1971	*1970*
Income:		
Interest on loans	$1,068,800	$1,003,000
Loan fees and service charges	69,000	66,600
Interest and dividends on investments	64,800	68,400
Rental income, net	19,400	21,200
Loss on sale of investments	(16,600)	(9,000)
Total Income	1,205,400	1,150,200
Expenses:		
General and administrative expenses	184,200	167,400
Provision for loan losses	25,000	32,000
Interest on savings accounts	791,000	766,200
Other interest expense	52,400	70,000
Total Expenses	1,052,600	1,035,600
Income Before Income Taxes	152,800	114,600
Income taxes (Notes 6 and 8):		
Currently payable	21,200	14,200
Deferred	18,200	12,200
	39,400	26,400
Net Income	$ 113,400	$ 88,200

See Notes to Financial Statements.

Alternative Format
CSM Mutual Savings and Loan Association
Statement of Income

Years Ended September 30, 1971 and 1970

	1971	1970
Investment revenue (A):		
First mortgage loans (including amortization of deferred loan fees)	$1,000,000	$ 950,000
Investment securities	64,800	68,400
Other loans	68,800	53,000
Total Investment Revenue	1,133,600	1,071,400
Cost of money:		
Interest on savings accounts	$ 791,000	$ 766,200
Other interest expense	52,400	70,000
	843,400	836,200
Excess of investment revenue over cost of money	$ 290,200	$ 235,200
Other loan fees and service charges (B)	69,000	66,600
Other operating income (rent, net)	19,400	21,200
	378,600	323,000
Expenses:		
General and administrative expenses	184,200	196,400
Provision for loan losses	25,000	3,000
Total Expenses	209,200	199,400
	169,400	123,600
Loss on sales of investments	(16,600)	(9,000)
Income Before Income Taxes	152,800	114,600
Income taxes (Notes 6 and 8):		
Currently payable	21,200	14,200
Deferred	18,200	12,200
	39,400	26,400
Net Income	$ 113,400	$ 88,200

See Notes to Financial Statements.

EXPLANATORY NOTES:

(A) Investment revenue includes interest, dividends, amortization of discounts and amortized loan fees (representing yield) and is net of amortization of premiums.

(B) Represents miscellaneous items not ordinarily includable in investment revenue.

(C) The above income statement format can be adopted by stock associations as well as mutual associations provided data with respect to "net income per share" is presented (see page 86).

CSM Mutual Savings and Loan Association
Statement of Retained Income
Years Ended September 30, 1971 and 1970

	1971	*1970*
Appropriated to general reserves (Note 5):		
Balance, October 1	$1,379,500	$1,326,500
Allocation of net income	48,200	53,000
Balance, September 30	1,427,700	1,379,500
Unappropriated:		
Balance, October 1	717,600	682,400
Allocation of net income	65,200	35,200
Balance, September 30	782,800	717,600
Total Retained Income	$2,210,500	$2,097,100

See Notes to Financial Statements.

CSM Mutual Savings and Loan Association
Statement of Changes in Financial Position
Years Ended September 30, 1971 and 1970

	1971	1970
Funds Were Obtained From:		
Operations:		
Net income	$ 113,400	$ 88,200
Add:		
Provision for losses on loans	25,000	32,000
Depreciation and other items	58,000	64,800
Total from operations	$ 196,400	$ 185,000
Loan principal repayments	2,087,000	1,796,000
Net increase in savings accounts	1,750,000	891,500
Sales of loans and real estate acquired through foreclosure	513,200	216,900
Decrease in cash and securities	62,000	137,500
Other receipts (net)	27,400	46,300
Total	$4,636,000	$3,273,200
Funds Were Used For:		
Loan disbursements	$4,380,300	$3,174,900
Repayment of FHLB advances	200,000	50,000
Net investment in FHLB capital stock and FSLIC prepayments	55,700	48,300
Total	$4,636,000	$3,273,200

See Notes to Financial Statements.

CSM Mutual Savings and Loan Association
Notes to Financial Statements

1. *Loans Receivable.* Loans receivable at September 30, 1971 and 1970 consist of the following:

	1971	*1970*
First mortgage loans	$18,737,500	$17,245,000
Savings account loans	585,000	522,000
FHA Title I improvement loans	86,400	94,500
Student loans	73,100	81,200
Other loans	18,000	32,300
	19,500,000	17,975,000
Less:		
Allowance for losses	175,000	155,000
Undisbursed portion of loans in process	116,050	365,600
Unamortized loan and commitment fees	67,500	58,995
	358,550	579,595
	$19,141,450	$17,395,405

2. *Notes Payable.* Notes payable at September 30, 1971 consist of the following:

7 percent note to bank, payable December 16, 1971. United States Government obligations of $175,000 pledged as collateral.	$ 75,000
6¾ percent note to bank, payable May 5, 1972. United States Government obligations of $105,000 pledged as collateral.	30,000
	$105,000

3. *Advances From Federal Home Loan Bank.* The advances, with interest currently at 5½ percent, mature at various dates through February 8, 1973. Stock of the Federal Home Loan Bank and real estate loans of approximately $1,225,000 are pledged as collateral.

4. *Office Properties and Equipment.* Office properties and equipment at September 30, 1971 and 1970 are summarized by major classification as follows:

	1971	*1970*
Land	$ 100,000	$ 100,000
Buildings	1,000,000	1,000,000
Furniture and equipment	400,000	392,500
	1,500,000	1,492,500
Accumulated depreciation	235,000	190,000
	$1,265,000	$1,302,500

5. *General Reserves.* In connection with the insurance of savings accounts by the Federal Savings and Loan Insurance Corporation, the association is required to maintain general reserves which may be used only for absorbing losses. These reserves are not related to amounts of losses actually anticipated, and the appropriations thereto have not been charged against income.

6. *Federal Income Taxes.* The association has qualified under provisions of the Internal Revenue Code which permit it to deduct from taxable income an allowance for bad debts based on a percentage of taxable income before such deduction. The Tax Reform Act of 1969 gradually reduces this deduction to 40 percent in 1979. The rate for 1970 was 57 percent and for 1971 is 54 percent.

Appropriated and unappropriated retained income at September 30, 1971 include earnings of approximately $1,345,000 representing such bad debt deductions, for which no provision for federal income taxes has been made. In the future, if the association does not meet the federal income tax requirements necessary to permit it to deduct an allowance for bad debts, the association's effective tax rate could increase to a maximum of 48 percent under present law.

The deferral of federal income taxes arises principally from the recognition of items as income for tax purposes in periods different from the periods in which they were included in the financial statements.

7. *Retirement Plan.* The association has a noncontributory retirement plan for all eligible employees. The contribution for the cost of the plan amounted to $23,600 for the year ended September 30, 1971, which includes the amortization of prior service costs over a 30-year period. The association's policy is to fund pension costs accrued. The actuarially computed value for vested benefits as of September 30, 1971, exceeded the value of the retirement fund at that date by approximately $103,000.

8. *Depreciation.* The association computes depreciation on its property and equipment on a straight-line basis over the estimated useful lives of the various classes of assets. Depreciation included in the statement of income amounted to $38,000 for the year ended September 30, 1971. For income tax purposes, accelerated methods are used and appropriate provision has been made to give effect to applicable deferred income taxes which may be payable in future years.

A Stock Association

To the Directors of CSM
Savings and Loan Association

We have examined the statement of financial condition of the CSM Savings and Loan Association as of December 31, 1971, and the related statements of income, stockholders' equity, and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying statements present fairly the financial position of CSM Savings and Loan Association at December 31, 1971, the results of its operations and changes in financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Signature

City, State
Date

NOTE: Present requirements of FHLBB Bulletin PA-6 provide that when comments relative to the system of internal control are presented to management in a separate report, the report of audit should contain a reference to such other report. Accordingly, the following paragraph is illustrative of a means of responding to this requirement in reports to be filed with the District Chief Examiner of the FHLBB; the paragraph should not be included in published reports or reports for other purposes.

> Our comments relative to the system of internal control have been (will be) submitted separately to the Association's Board of Directors.

CSM Savings and

Statement of

December 31,

Assets	*1971*	*1970*
Cash	$ 425,000	$ 396,500
U.S. Government obligations, at amortized cost (approximate market 1971 $890,000) (Note 2)	975,000	1,073,000
Other investments, at cost	82,500	75,000
Loans receivable, net (Notes 1 and 3)	19,141,450	17,395,405
Accrued interest receivable	186,000	159,000
Real estate owned, at cost, less allowance for losses of $67,500 in 1971 and $65,000 in 1970	735,000	718,300
Federal Home Loan Bank Stock, at cost (Note 3)	240,000	215,500
Office properties and equipment, at cost, less accumulated depreciation of $235,000 in 1971 and $190,000 in 1970 (Notes 4 and 8)	1,265,000	1,302,500
Prepayments to FSLIC secondary reserve	255,000	223,800
Prepaid expenses and other assets	11,500	16,400
Total Assets	$23,316,450	$21,575,405

See Notes to Financial Statements.

Loan Association

Financial Condition

1971 and 1970

Liabilities and Stockholders' Equity	*1971*	*1970*
Liabilities:		
Savings accounts	$20,000,000	$18,250,000
Notes payable (Note 2)	105,000	90,000
Advances from Federal Home Loan Bank (Note 3)	475,000	675,000
Accrued interest payable	237,600	223,155
Advances by borrowers for taxes and insurance	176,500	161,735
Accounts payable and accrued expenses	17,900	11,400
Federal and state income taxes (Note 6)	21,150	12,415
Deferred income taxes (Note 8)	72,800	54,600
Total Liabilities	21,105,950	19,478,305
Stockholders' Equity:		
Capital stock, $1.00 par value, authorized 2,500,000 shares, issued and outstanding 408,000 shares (400,000 in 1970)	408,000	400,000
Additional paid-in capital	64,000	48,000
Retained income (Notes 5 and 6)		
Appropriated to general reserves	1,427,750	1,379,550
Unappropriated	334,750	291,118
Total	1,762,500	1,670,668
Market value of 2% stock dividend	(24,000)	(21,568)
	1,738,500	1,649,100
Total Stockholders' Equity	2,210,500	2,097,100
Total Liabilities and Stockholders' Equity	$23,316,450	$21,575,405

CSM Savings and Loan Association
Statement of Income
Years Ended December 31, 1971 and 1970

	1971	1970
Income:		
Interest on loans	$1,068,800	$1,003,000
Loan fees and service charges	69,000	66,600
Interest and dividends on investments	64,800	68,400
Rental income, net	19,400	21,200
Loss on sale of investments	(16,600)	(9,000)
Total Income	1,205,400	1,150,200
Expenses:		
General and administrative expenses	164,200	167,400
Provision for loan losses	25,000	32,000
Interest on savings accounts	811,000	766,200
Other interest expense	52,400	70,000
Total Expenses	1,052,600	1,035,600
Income Before Income Taxes	152,800	114,600
Income taxes (Notes 6 and 8):		
Currently payable	21,200	14,200
Deferred	18,200	12,200
	39,400	26,400
Net Income	$ 113,400	$ 88,200
Net income per share (based on average number of shares outstanding)	$.28	$.22

See Notes to Financial Statements.

Explanatory Note: See page 77 for an alternative format of presenting the "Statement of Income."

CSM Savings and Loan Association
Statement of Stockholders' Equity
Years Ended December 31, 1971 and 1970

	1971	*1970*
Capital stock:		
Balance, January 1	$ 400,000	$ 392,157
Par value of 2% stock dividend	8,000	7,843
Balance, December 31	408,000	400,000
Capital surplus:		
Balance, January 1	48,000	34,275
Excess of market value of stock dividend over par value of stock issued (a)	16,000	13,275
Balance, December 31	64,000	48,000
Retained income (Notes 5 and 6)		
Appropriated to general reserves:		
Balance, January 1	1,379,550	1,326,550
Allocation of net income	48,200	53,000
Balance, December 31	1,427,750	1,379,550
Unappropriated:		
Balance, January 1	269,550	255,918
Allocation of net income	65,200	35,200
Balance, December 31	334,750	291,118
Total	$1,762,500	$1,670,668
Market value of 2% stock dividend (a)	(24,000)	(21,568)
Total Retained Income	$1,738,500	$1,649,100
Total Stockholders' Equity	$2,210,500	$2,097,100

See Notes to Financial Statements.

EXPLANATORY NOTE: (a) Market value per share of common stock was assumed to be $3.00 in 1971 and $2.75 in 1970.

CSM Savings and Loan Association
Statement of Changes in Financial Position
Years Ended December 30, 1971 and 1970

	1971	*1970*
Funds Were Obtained From:		
Operations:		
Net income	$ 113,400	$ 88,200
Add:		
Provision for losses on loans	25,000	32,000
Depreciation and other items	58,000	64,800
Total from operations	$ 196,400	$ 185,000
Loan principal repayments	2,087,000	1,796,000
Net increase in savings accounts	1,750,000	891,500
Sales of loans and real estate acquired through foreclosure	513,200	216,900
Decrease in cash and securities	62,000	137,500
Other receipts (net)	27,400	46,300
Total	$4,636,000	$3,273,200
Funds Were Used For:		
Loan disbursements	$4,380,300	$3,174,900
Repayment of FHLB advances	200,000	50,000
Net investment in FHLB capital stock and FSLIC prepayments	55,700	48,300
Total	$4,636,000	$3,273,200

See Notes to Financial Statements.

CSM Savings and Loan Association
Notes to Financial Statements

1. *Loans Receivable.* Loans receivable at December 31, 1971 and 1970 consist of the following:

	1971	*1970*
First mortgage loans	$18,737,500	$17,245,000
Savings account loans	585,000	522,000
FHA Title I improvement loans	86,400	94,500
Student loans	73,100	81,200
Other loans	18,000	32,300
	19,500,000	17,975,000
Less:		
Allowance for losses	175,000	155,000
Undisbursed portion of loans in process	116,050	365,600
Unamortized loan and commitment fees	67,500	58,995
	358,550	579,595
	$19,141,450	$17,395,405

2. *Notes Payable.* Notes payable at December 31, 1971 consist of the following:

7 percent note to bank, payable July 10, 1972. United States Government obligations of $175,000 pledged as collateral.	$ 75,000
6¾ percent note to bank, payable November 4, 1972. United States Government obligations of $105,000 pledged as collateral.	$ 30,000
	$105,000

3. *Advances From Federal Home Loan Bank.* The advances, with interest currently at 5½ percent, mature at various dates through August 16, 1973. Stock of the Federal Home Loan Bank and real estate loans of approximately $1,225,000 are pledged as collateral.

4. *Office Properties and Equipment.* Office properties and equipment at December 31, 1971 and 1970 are summarized by major classification as follows:

	1971	*1970*
Land	$ 100,000	$ 100,000
Buildings	1,000,000	1,000,000
Furniture and equipment	400,000	392,500
	1,500,000	1,492,500
Accumulated depreciation	235,000	190,000
	$1,265,000	$1,302,500

5. *General Reserves.* In connection with the insurance of savings accounts by the Federal Savings and Loan Insurance Corporation, the association is required to maintain general reserves which may be used only for absorbing losses. These reserves are not related to amounts of losses actually anticipated, and the appropriations thereto have not been charged against income.

6. *Federal Income Taxes.* The association has qualified under provisions of the Internal Revenue Code which permit it to deduct from taxable income an allowance for bad debts based on a percentage of taxable income before such deduction. The Tax Reform Act of 1969 gradually reduces this deduction to 40 percent in 1979. The rate for 1970 was 57 percent and for 1971 is 54 percent.

Appropriated and unappropriated retained income at December 31, 1971 include earnings of approximately $1,345,000 representing such bad debt deductions, for which no provision for federal income taxes has been made. If, in the future, this portion of appropriated and unappropriated retained income is used for any purpose other than to absorb bad debt losses, federal income taxes may be imposed at the then applicable rates. In the future, if the association does not meet the federal income tax requirements necessary to permit it to deduct an allowance for bad debts, the association's effective tax rate could increase to a maximum of 48 percent under present law.

The deferral of federal income taxes arises principally from the recognition of items as income for tax purposes in periods different from the periods in which they were included in the financial statements.

7. *Retirement Plan.* The association has a noncontributory retirement plan for all eligible employees. The contribution for the cost of the plan amounted to $23,600 for the year ended December 31, 1971, which includes the amortization of prior service costs over a 30-year period. The association's policy is to fund pension costs accrued. The actuarially computed value for vested benefits as of December 31,

1971 exceeded the value of the retirement fund at that date by approximately $103,000.

8. *Depreciation.* The association computes depreciation on its property and equipment on a straight-line basis over the estimated useful lives of the various classes of assets. Depreciation included in the statement of income amounted to $38,000 for the year ended December 31, 1971. For income tax purposes, accelerated methods are used and appropriate provision has been made to give effect to applicable deferred income taxes which may be payable in future years.

Illustrative Report on Internal Control

The following is an example of an independent auditor's report on internal control. The content of such a letter may vary and the example is based on assumed conditions. Furthermore, the weaknesses described have been assumed to be material for the purpose of illustration. When preparing such reports, independent auditors should refer to Statement on Auditing Procedure No. 49.

Date

To the Directors of CSM Mutual
Savings and Loan Association

We have examined the financial statements of CSM Mutual Savings and Loan Association for the year ended September 30, 1971, and have issued our report thereon dated November 23, 1971. As a part of our examination we reviewed and tested the Association's system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards. Under these standards the purpose of such evaluation is to establish a basis for reliance thereon in determining the nature, timing, and extent of other auditing procedures that are necessary for expressing an opinion on the financial statements.

The objective of internal accounting control is to provide reasonable, but not absolute, assurance as to the safeguarding of assets against loss from unauthorized use or disposition and the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that the cost of a system of internal accounting control should not exceed the benefits derived, and also recognizes that the evaluation of these factors necessarily requires the use of estimates and judgments by management.

There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal accounting control. In the performance of most control procedures errors can result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personal factors. Control procedures whose effectiveness depends upon segregation of duties can be circumvented by collusion. Similarly, control procedures can be circumvented intentionally by management with respect either to the execution and recording of transactions or with respect to the estimates and judgments required in the preparation of financial statements. Further, projection of any evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions, and that the degree of compliance with the procedures may deteriorate.

Our study and evaluation of the Association's system of internal accounting control for the year ended September 30, 1971, which was made for the purpose set forth in the first paragraph above, was not designed for the purpose of expressing an opinion on internal accounting control and it would not necessarily disclose all weaknesses in the system. However, such study and evaluation disclosed the following conditions that we believe to be material weaknesses:

Computerized savings accounting. Our recommendations for changes or additions to the "on-line" savings account system include the following:

1. The method and type of "hold" to be placed on miscellaneous savings accounts such as accounts pledged as collateral and dormant accounts should be reviewed. All accounts of this nature should have holds, which cannot be overridden by teller personnel.
2. At present, no control is in effect to insure that the service bureau is correctly computing interest on savings accounts. We recommend that the Association review and check the interest being calculated and posted to the savings accounts on a test basis.
3. In view of the relative accessibility of the auditor's key at the smaller offices, we recommend that the Association obtain a printout regularly of accounts from which a dormant hold has been removed. This listing should be reviewed by an independent person and significant transactions should be confirmed.
4. We recommend that, in addition to the reports which you are now receiving from the service bureau, you make arrangements to obtain the following:
    a. Their daily exception report would provide a listing of all unusual transactions, such as auditor's overrides, no-book transactions, activity on pledged accounts, transactions over a specified dollar amount, holds applied and/or removed, etc. This report, when reviewed by a responsible employee independent of the teller and cash functions, provides an excellent control over the above transactions.

b. A listing of new account information (name, address, social security number, etc.) could be obtained periodically and used to proof the setup of new accounts.

Elimination of dormant account computer holds. We noted during our audit that on several dormant accounts, holds were removed by Association personnel because of customers' having their passbooks updated for dividends. These holds were removed at the end of the business day, using the daily record of hold transactions as the source for the removal of the hold without any other verification. We recommend that, when a dormant account savings book is presented for dividend posting, the hold be removed through use of the supervisor's override key at the time of the transaction. This would provide necessary assurance of the validity of the transaction not otherwise possible through review of the daily record of hold transactions.

Fixed assets. The Association does not have a formal procedure requiring a physical inventory of fixed assets. To provide effective accountability over equipment owned and to assure reliability of records maintained, we recommend a physical inventory be taken.

Savings account loans. In performing our test on savings account loans of the Association, we noted that the passbooks held as collateral had not been posted up-to-date to agree with the customer's subsidiary ledger card. The passbooks and the subsidiary ledger cards should be posted simultaneously.

Loans in excess of $100,000. The Association has approximately $200,000 of loans due from one borrower. Since these loans represent a concentration of risk, audited financial statements and/or Dun & Bradstreet reports should be periodically obtained and reviewed by the officers of the Association.

Participation loan income. As the Association acquires more participation loan interests, it becomes more difficult to assure that interest income is properly recorded monthly. To facilitate this we recommend adoption of a simple register to be used to assure that income is received from each participation monthly. If an amount is not received in any month, it can be readily estimated and recorded to preclude income distortions.

Escrow. In reviewing the Association's escrow payments, we noted two areas where improvements could be made. The first is that the monthly escrow payments on many mortgage accounts appear to be low, based on current tax rates. We recommend that the escrow payments on all mortgages be reviewed for adequacy and revised accordingly. The second area is that tax receipts are not always obtained when a customer pays his own taxes. We recommend that the Association obtain these tax receipts and make a record thereof.

Savings account passbooks. The Association holds approximately 100 passbooks in addition to those collateralizing share loans. This practice should be discouraged wherever possible. Where the customer cannot be convinced otherwise, a written request should be obtained. The request forms should be obtained from the customer and controlled by the managing officer at each location. As is common practice, passbooks held in the Association should be placed under dual control and should be updated at each dividend period.

Teller operations. The window posting machines are cleared by the head teller at the end of each day. We recommend that an employee who does not act as a teller perform this function.

Register clearing keys of the window posting machines are controlled by an employee who has access to cash. We recommend that an employee who does not have access to cash control the keys.

The key and the signature plate for the facsimile signature machine are controlled by an employee who has access to cash. We recommend that an employee who does not have access to cash control the key and the signature plate.

In the event you wish to discuss the matters presented herein, we shall be pleased to discuss them with you at your convenience.

Signature

APPENDIX

Glossary

Terms Common to Savings and Loan Associations

Abstract of title. A history of title transactions or conditions affecting the title of a property. Such a document does not convey title or guarantee title. *See* Title opinion.

Acquisition credits. *See* Loan fee.

American Savings and Loan Institute. An educational organization which offers correspondence courses and classroom instruction in S&L-oriented subjects. The Institute has chapters in many cities.

Amortized mortgage. A loan which requires regular periodic (usually monthly) principal payments as opposed to a straight mortgage. *See* Straight mortgage.

Appraised value. A valuation made by an approved or licensed appraiser involving facts, assumptions, and techniques considered by the appraiser to be appropriate in a given circumstance. An association appraiser may be a director or an employee. An independent appraiser, usually licensed, is not an employee of the association.

Bond. Promissory note.

Building loan. *See* Construction loan.

Capital stock associations. Associations having stockholders, as opposed to mutual associations. At the time of this writing all capital stock associations are state-chartered corporations.

Capital stock. Is variously referred to as nonwithdrawable shares, permanent reserve shares, or guarantee (also guaranty) stock. Ownership of capital stock associations rests with the stockholders. In some states, owners of savings accounts and borrowers in the S&L have voting rights even though they are not stockholders. The board of directors is elected by the stockholders and members. It is customary for members to sign proxies delegating their rights to an officer, director, stockholder, or proxy committee.

Certificate of title. Opinion written by attorney as to condition of the title to property. The attorney's opinion is based on his findings from examining public records. *See* Title opinion.

Closing costs. Amount paid by borrower at closing of loan. Generally includes loan fee, attorney's fee, cost of abstract of title or title insurance, recording fee, and appraisal fee.

Condominium. A system of direct ownership of a single unit in a multi-unit structure. The individual owns the unit in much the same manner as if it were a single-family dwelling; he holds direct legal title to the unit and proportionate interest in the common areas and underlying ground. *See* Co-operative.

Co-operative. A system of indirect ownership of a single unit in a multi-unit structure. The individual owns shares in a nonprofit corporation which holds title to the building; the corporation in turn gives the owner a long-term proprietary lease to the unit. *See* Condominium.

Construction loan. First mortgage loan to finance construction costs.

Cost of real estate owned. (1) Acquired by purchase—contract price plus direct acquisition costs, including closing costs. (2) Acquired through foreclosure or by deed in lieu of foreclosure—remaining loan balance reduced by any balances in loans in process and in deferred income that are related to the property, plus (a) acquisition cost, (b) taxes and other charges accrued or delinquent at date of foreclosure, and (c) rehabilitation or improvement costs incurred, reduced by any valuation allowance existing or provided at the time of foreclosure.

Current net selling price. Contract or expected price for prompt sale, reduced by direct selling expenses such as sales commissions.

Deed. A written instrument conveying title to real estate. A warranty deed guarantees a perfect title, and the grantee is entitled to recover from the grantor any loss sustained by reason of imperfect title. A quit-claim deed conveys only the grantor's title, whatever its state. A deed-taken-in-lieu-of-foreclosure is usually a quit-claim deed. *See also* Quit-claim deed.

Deed of trust. Conveyance of title to a trustee as security for a debt.

Deficiency judgment. Judgment against a debtor which represents the excess of his debt over proceeds realized from the security to the debt.

Deposit association. A savings and loan association which designates savings accounts as "deposits" rather than "member accounts" or "share accounts."

Direct holding costs. The costs or expenses directly associated with holding real estate owned including (a) real estate taxes and similar assessments, (b) insurance, and (c) maintenance and upkeep.

Direct-reduction mortgage. Mortgage being amortized over a definite period of time having periodic (usually monthly) payments of a like amount with the payment being applied first to interest and then to principal.

Dividend. Amount paid to savers (members) (called interest in some states, and not to be called interest in other states) and an expense of the S&L in arriving at net income; or, amount paid to stockholders of capital stock associations.

Dividend-anticipation loan. *See* Passbook loan.

Dividend-day loan. *See* Passbook loan.

Education loans. Loans made to students or their parents to finance higher education.

Escheat. Process whereby unclaimed property, including savings accounts, wages, and dividends, passes to the state. The laws of the states vary.

Escrow. Delivery of deed to a third person who will release the deed to the grantee upon the fulfillment of certain specified conditions. Also commonly used to designate accounts with which are credited the periodic deposits by borrowers for the payment of real estate taxes and insurance premiums when they become due.

Estimated discount factor. A discount percentage applied to an estimated future cash selling price (or its equivalent) of real estate owned to reduce it to present value in the determination of estimated net realizable value.

Estimated net realizable value. Estimated cash sales price (or its equivalent) at projected date of disposition reduced by the sum of (a) estimated costs of disposition, (b) estimated costs of completion or improvement, (c) estimated direct holding costs during the projected holding period including taxes, maintenance and insurance, and (d) an estimated discount factor for the cost of money representing an allocation of interest expense.

Farmers Home Administration. A government agency which provides mortgage credit in areas (towns of not more than 10,000 population) where private credit agencies are unable to fulfill the needs.

Federal guide. A loose-leaf service published by the United States Savings and Loan League covering laws and regulations pertinent to S&Ls.

Federal Home Loan Bank (FHLB). Any one of the regional (presently 12) banks comprising the Federal Home Loan Bank System. Each bank is identified by including the name of the city in which it is located in the title. The primary function of the FHLB System is to provide reserve credit for thrift institutions of the savings and loan type, savings banks, and insurance companies engaging in long-term mortgage financing.

Federal Home Loan Bank Board (FHLBB). A bipartisan three-member board appointed by the President of the United States, with the consent of the Senate. The FHLBB's basic functions are to supervise and regulate the Federal Home Loan Bank System, federally chartered savings and loan associations, and the Federal Savings and Loan Insurance Corporation.

Federal Home Loan Bank System. The network of regional Federal Home Loan Banks.

Federal Home Loan Mortgage Corporation (FHLMC). A corporation whose stock is owned by the 12 Federal Home Loan Banks. The corporation functions similarly to the Federal National Mortgage Association (FNMA) and also may provide a secondary market for conventional mortgages as well as purchase participations in loans. The FHLMC will also make commitments to purchase loans in the future at a fixed price.

Federal Housing Administration (FHA) and FHA-insured loans. The National Housing Act, approved in 1934, established the FHA. The FHA does not make loans; rather, it insures certain types of loans made by S&Ls and other lenders. Principally, insofar as S&Ls are concerned, the types of insured loans are (a) unsecured property improvement loans, and (b) mortgage loans on 1- to 4-family homes.

Insurance premiums are paid by the borrower to the S&L which remits to the FHA. On FHA Title I improvement loans a reserve account for each lender is maintained by the FHA. The regulations and the amount of the reserve account, insofar as FHA Title I loans are concerned, govern the amount of insurance by loan and by lender. These regulations are complex and subject to change, and their substance is not recited here.

If an insured mortgage loan is defaulted, the S&L receives cash approximating 90 percent of the amount due the association and Certificates of Claim representing the remainder plus expenses sustained in foreclosure, rehabilitation expenses, etc. Recommended procedure is to record such Certificates at $1.

Appraisals of property securing insured mortgage loans are required to be made by FHA-approved appraisers.

Federal National Mortgage Association (FNMA). Often referred to as "Fanny Mae." Its purpose is to provide a secondary market for residential housing mortgages. Federally chartered S&Ls (state laws vary) may sell mortgages to FNMA and thereby invest in FNMA's stock, and may invest in FNMA's obligations.

FHA Title I Loan. Home improvement loan insured by FHA.

Fidelity bond. Insurance against losses arising from dishonest acts of employees and involving money, merchandise, or other property; persons or positions may be covered.

First mortgage. A mortgage representing a first lien against real estate.

Foreclosure. Legal process protecting the mortgagee in case of nonpayment and other defaults on the mortgage by the mortgagor. *See also* Quit-claim deed.

Foreclosed real estate. Real estate acquired by foreclosure or deed in lieu of foreclosure as distinguished from real estate purchased for sale of development and association premises.

GI loan. *See* VA loan.

Government National Mortgage Association (GNMA). A wholly owned corporate instrumentality of the United States Government which purchases, services, and sells mortgages insured or guaranteed by the Federal Housing Administration (FHA) and the Veterans Administration (VA), and may perform other secondary market functions to support the home mortgage market. The Association is referred to as "Ginny Mae."

Grant. Transfer of real estate.

Grantee. One to whom real estate is granted.

Grantor. One who grants real estate.

Guarantee-stock associations. *See* Capital stock associations.

Holding costs. The costs or expenses incurred in the process of holding real estate owned for sale, including, but not limited to, (a) real estate taxes and similar assessments, (b) insurance, (c) maintenance and upkeep, and (d) cost of money, representing an allocation of interest expense. Estimated holding costs during the projected holding period include the total above costs estimated to be incurred during the period of time from the date of determination to the projected date of disposition.

Impounds. Advance payments by borrowers for taxes and insurance.

Improvement loan. A loan for improvement of real estate. Usually such loans are unsecured. *See* FHA Title I loan and uninsured improvement loan.

Initial service charge. *See* Loan fee.

Interest. Amount paid or received for use of money. *See also* Dividends.

Investment certificate. A savings account in the form of a certificate issued by an S&L, generally in specified denominations such as $1,000. Certificate accounts may differ from passbook accounts in several ways. Dividends (or interest) may be paid by check to a certificate holder or credited to his account. Certificates may have a specific maturity date; if a saver does not withdraw his funds prior to the maturity date, he receives a higher rate of earnings than paid on a passbook account. On the other hand, if a saver withdraws his funds prior to maturity, his earnings may be penalized. Certificates do not carry stockholder liability.

Junior mortgage. A mortgage, e.g., second mortgage, subordinate to prior or other mortgages.

Legal reserve. Reserve required to be maintained by federally or state-chartered association. *See* Reserves.

Level-payment mortgage. *See* Direct-reduction mortgage.

Lien. A claim upon property, which property represents security against a debt.

Liquidity. See Sections 523.0 through 523.14 of *Rules and Regulations for the Federal Home Loan Bank System.* These requirements are imposed on all members of the FHLB System.

Loan fee. Amount charged by mortgagee for granting loan. Variously referred to as "points," "acquisition credits," or "initial service charge." Loan fees are generally stated as a percent of the face of the loan. The charge is made generally to cover the cost of placing the loan on the books, but may also represent, in part, an adjustment of yield.

Loans to facilitate. Loan made to expedite the sale of real estate owned.

Manager's manual. A loose-leaf service published by the National League of Insured Savings Associations, covering laws and regulations pertinent to savings and loan associations.

Market. As related to real estate owned, market is either current net selling price or estimated net realizable value.

Member. One owning a savings account in or one borrowing from an S&L. In a federally chartered S&L a savings member has one vote for each $100 or fraction thereof in savings, and a borrowing member has one vote (plus his savings vote, if any), with a maximum of fifty votes per member. Voting rights are not uniform for state-chartered associations. Therefore, the state laws and the S&L's charter and bylaws should be consulted.

Mortgage. A pledge or security of particular property for the payment of a debt or the performance of some other obligation.

Mutual associations (mutuals). S&Ls having no capital stock, as opposed to capital stock S&Ls. Mutual S&Ls are state-chartered or federally chartered corporations. Ownership rests with the members who elect the board of directors.

National League of Insured Savings Associations. One of the two nationwide S&L trade organizations. *See* United States Savings and Loan League.

National League's Manager's Guide. A loose-leaf service published by the National League covering laws and regulations pertinent to S&Ls.

National Society of Controllers and Financial Officers of Savings Institutions. An organization whose membership consists principally of accounting and auditing officers and financial personnel of S&Ls. This organization is allied with the United States Savings and Loan League.

Net carrying amount. The cost, as relates to real estate owned, reduced by related allowances for losses.

Open-end mortgage. Mortgage permitting additional secured advances under the original mortgage.

Participation. Partial ownership in a loan.

Passbook. Book issued by S&L to borrower or saver for recording transactions in the customer's account.

Passbook loan. Loan secured by savings account of member. Also commonly called savings account loan, share loan, dividend-day loan, or dividend-anticipation loan.

Permanent stock associations. *See* Capital stock associations.

Points. *See* Loan fee.

Prepayment penalty. Penalty for payment of loan prior to its scheduled maturity.

Proxy. A member's authorization to have another person vote in his stead.

Quit-claim deed. When the holder of a first lien takes property under a quit-claim deed, as opposed to foreclosure, his title is subject to amounts owing under any other liens on the property. *See* Deed.

Real estate owned. Property acquired (a) for sale or development or (b) through foreclosure or deed in lieu of foreclosure (foreclosed real estate).

Real estate sold on contract. Contract for the sale of property under which the seller retains title, but the property is in the possession of the buyer.

Reserves. Reserves typically are *general* or *specific reserves.* General reserves include the legal reserves, federal insurance reserve, reserve for contingencies, and reserve for bad debts when this reserve is classified in the equity section of the balance sheet. Such reserves are considered appropriated (restricted) retained income (undivided profits).

Specific reserves represent either (a) valuations against asset accounts, e.g., allowance for losses or (b) liabilities, e.g., bonuses payable on savings accounts.

Savings account loan. *See* Passbook loan.

Service corporations. Subsidiaries of associations which are authorized to perform related functions, such as an insurance agency, escrow agency, conveyancing, etc.

Share loan. *See* Passbook loan.

Signature card. Card bearing the saving member's signature. The card is kept on file by the S&L for purpose of verifying the member's signature when savings are withdrawn. The signature card contains the contract between the saver and the S&L. Most S&Ls also maintain a signature card file of borrowing members. Some S&Ls incorporate a revocable, continuing proxy on the signature card.

Stock association. *See* Capital stock association.

Straight mortgage. One requiring no payments of principal until maturity. Interest generally is paid periodically.

Surplus. Unappropriated retained income in a federal S&L. In some state-chartered S&Ls (e.g., New York) it may be a legal reserve available to absorb losses only.

Title opinion. Opinion written by attorney after examining abstract of title (or perhaps the documents themselves instead of an abstract) wherein he states his opinion as to the state of the title to property. *See* Certificate of title.

Title policy. Policy issued by title insurance company guaranteeing that title to property is as indicated in the policy.

Torrens certificate. Certificate issued by registrar of titles, setting forth state of title to property. Such certificates are issued in several metropolitan areas, e.g., New York, Chicago, and Boston.

Trust deed. *See* Deed of trust.

Undivided profits. Unappropriated retained income.

Uninsured improvement loan. Improvement loan not insured by FHA nor guaranteed by VA.

United States Savings and Loan League. One of the two nationwide S&L trade organizations. *See* National League of Insured Savings Associations.

Veterans Administration (VA) insured loan. A loan insured or partially guaranteed by the VA pursuant to the The Serviceman's Readjustment Act of 1944 as Amended. At the option of the lender the loan may be insured or partially guaranteed. If the lender expresses no option, the VA processes the loan as a partially guaranteed loan. Practically all lenders use the partial-guarantee route.

Warranty deed. *See* Deed.

Statement of Position on SAVINGS AND LOAN SUBORDINATED DEBT

January 24, 1974

Issued by the Accounting Standards Division
American Institute of Certified Public Accountants

NOTES

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

Savings and Loan Subordinated Debt

The AICPA Accounting Standards Division recommends that subordinated debt securities issued by savings and loan associations be classified as debt on the associations' balance sheets. Although these securities may be wholly or partially considered as "net worth" for regulatory purposes, the Division notes that they are debt instruments and that they require repayment. Accordingly, it views them as debt and not as part of capital for financial reporting purposes. Federal regulations precluded S&Ls from issuing such debt until recently.

January 24, 1974

Statement of Position No. 2, "Savings and Loan Subordinated Debt," was adopted by the Accounting Standards Executive Committee upon the recommendation of the AICPA Federal Government Division Task Force on Savings and Loan Associations.

Task Force on Savings and Loan Associations
January 24, 1974

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